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THE NEW YORK
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Accounting News and Trends

CPA SOCIETY'S OWN REFERRAL SERVICE

A statement describing the result of the first year's operation of the Referral Service of the Colorado Society of CPAs is presented in that Society's publication *The Report* (August 1961). At the inauguration of this service, all members of the Society were sent enrollment cards and those wishing to be included returned them. These cards were filed in the order in which they were received in the Society office and, as callers contacted the Society office asking for a CPA, they were referred to CPAs in the order in which the cards appeared. Most of the referral calls came in because of an advertisement which the Society runs in the yellow pages of the Denver telephone directory.

The first year results show that 47 referrals were made to CPAs who had enrolled with the Society office for this service. Questionnaires were sent to all CPAs receiving referrals and all but one questionnaire was returned. These replies revealed:

In 23 cases, just half, nothing came of the referral. In 19 of these cases the party requesting information did not contact the CPA, in one case the contact fell through after the initial meeting, and in three cases the referral was turned down by the CPAs for valid reasons.

In the other 23 cases the referrals worked out very satisfactorily. Seven of these referrals resulted in permanent tax clients, six in permanent audit or management service clients and six in a one-time engagement for a satisfactory fee. In the other four cases assistance was given the callers on minor problems for which no fee was charged.

Out of the 27 cases where the referring party actually contacted a CPA, a one-time or permanent fee engagement resulted 19 times. The fact that so many referrals resulted in a fee engagement is a particularly interesting result since the Referral Service was begun solely as a public relations and public service effort on the part of the Colorado Society. In view of these satisfactory results and since no apparent problems arose in its conduct during the first year, the Referral Service will be continued.

STAFF RECRUITING AID

An aid in recruiting staff accountants, referred to in *The Certificate* (June 1961) of the District of Columbia Institute of CPAs, may have been overlooked by some New York CPAs. Developed by the AICPA's advisory

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Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

committee on personnel recruiting, the aid is essentially a "how-to-do-it" brochure.

It contains two novel features inserted in end-flaps in the covers. One is a sample recruiting pamphlet. By combining this with a pattern letter included in the kit many CPAs could easily turn out a recruiting package for their own firms. Such a package would serve the same purpose as the expensive recruiting brochures published by some firms. The other novel feature is a long-playing record narrated by John L. Carey, assisted by a cast of Institute staff and junior accountants, illustrating good and bad approaches in interviewing job applicants.

The whole package is free on request to Institute members ($2 for others). The Institute hopes that all CPAs who hire junior accountants will write for a copy.

HOW TO PROCEED IF FRAUD IS DISCOVERED

Some suggested steps for an auditor to take after he discovers fraud is being practiced on a client are set forth in an article by Bert B. Weinstein entitled "What Happens After Fraud Is Uncovered?" (*The Illinois CPA* 1961 Autumn Issue).

The CPA must remember, of course, that he is a fact-finder and not a prosecuting attorney. To avoid embarrassment, he must check and recheck any apparent irregularities to be sure that they represent an embezzlement, defalcation or peculation, rather than a justified business practice which may be peculiar to the industry or to that client. Once the suspicion of the auditor has been aroused, he should extend the scope of his work sufficiently to prove or disprove the validity of his suspicions. Generally, if there are irregularities, further check may disclose a consistent pattern of such irregularities and probably others.

Assuming, however, that the CPA has incontrovertible proof of the existence of fraud, he must make an immediate decision as to what, to whom, and how to report his discovery to the client. As to what, the answer is clear —plain, unvarnished facts. Great care should be taken to avoid making accusations or drawing conclusions.

As to whom, the answer is "it depends." If there is any indication that a particular financial officer might be involved, the report should be made elsewhere. Just because a certain person has always received the auditor's report is no reason for first discussing the fraud situation with him. Judgment must be exercised and a decision made in the light of all the available facts.

As to how to make the report, the author suggests that in the initial stages the best method would be the questioning approach: "I have run across something which I don't understand. Possibly you could explain this transaction to me." Generally, when first presenting the findings, oral advices are preferable to written advices. This is not to say, however, that there is any reason to fear written advices to the client as long as there is strict adherence to ascertained facts. One other point: if an employee of the client is to be confronted with evidence gathered by the auditor, it should always be done by the employer, not the auditor, and preferably in the presence of the client's attorney, or, as a minimum, under his guidance and direction.

In this connection, it is important to avoid forewarning suspected employees in the initial stages, at least until management can make plans to take over records handled by the suspected employee. These very records may be needed to prove the extent of the loss to the client.

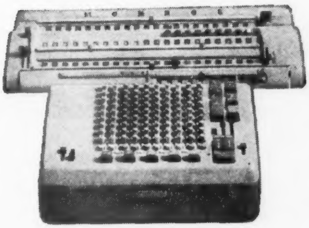
In concluding this portion of the article, the author states that the best

advice an auditor can give to management on what action to take is to contact, first, their attorney, and second, the bonding company. Thirdly, corrective measures should be recommended to prevent further losses, particularly if there are several parallel positions. As an example of this latter comment, the author cites a method of cheating a client which involved a salesman-driver who was one of 40 similar employees. Since this method of defalcation may have been known to others in this group of employees, it was important to plug the weaknesses and deficiencies in internal control which made the defalcation possible.

GRATIS SERVICES FOR A POTENTIAL CLIENT

The question of whether a fact-finding review of a potential client's records, without charge, for the purpose of collecting facts for feasibility study, represents a violation of professional ethics was considered by the Colorado State Board. Its conclusion appears in that State Society's publication, *The Report* (August 1961).

After an initial consideration of this question the Board referred it to the Committees on Professional Ethics of both the AICPA and the Colorado Society of CPAs. The opinion of both groups was that this procedure is not a violation of professional conduct. In the light of these decisions, and because of the similarity of the rules of both organizations to its own rules, the State Board ruled that there had been no violation in offering to do preliminary work, without charge, on the records of a client of another accounting firm for the purpose of making a feasibility study.



Letters to the Editor

COMMENT ON CANADIAN-U.S. INCOME TAX COMPARISON

As a Canadian taxpayer I was particularly interested in reading your comments in your August 1961 issue [Accounting News and Trends Department] entitled "Higher Income Tax in Canada." Like all taxpayers, I wish that my taxes were less and it would be some consolation to think that a lower tax structure in the United States could be used as a prod to bring Canadian tax rates down. The comparison suggested in the article, although it is mathematically correct, is unfortunately incomplete because it fails to bring into account the family allowances which are paid by the Government of Canada and which amount to either $6 or $8 per month per child depending on the child's age. In total, therefore, in the example given, while the Canadian taxpayer would have paid taxes of $250.50 he (or to be more exact, his wife) would have received family allowances of an even greater amount, the actual amount received in any year being not less than $360 or more than $480 depending on the age assortment of his children.

If the taxpayer's children were all over 16 years of age and still dependent or if for any other reason they were not entitled to family allowances, the exemption for dependents is increased. In the example given the Canadian tax would have been only $56 or $4 less than the United States tax. Incidentally, the Canadian taxpayer has no provincial or municipal income tax to pay unless he is a resident of Quebec, in which case, in the lower income levels at least, it would be reduced by the reduction in Federal income tax.

All of this does not mean that residents of Canada are not taxed at a higher level than are residents of the United States. Whether they are or not would require a study of taxes at all three levels of government and presumably the only conclusion would be that we both pay too much. The purpose of this letter, however, is not to berate tax levels but to let your readers know that when comparing Canadian and U. S. income tax rates the family allowance payments from our Federal government must be taken into account if a fair comparison is to be made.

J. R. M. Wilson, F.C.A.
Toronto, Canada

DEPRECIATION TREATMENT IN A FUNDS STATEMENT

Under the caption "The Where Got, Where Gone" statement on page 584 of the September 1961 issue of the N.Y. C.P.A., reference is made to:

> "Depreciation does not provide funds. However, since the net profit has been reduced by depreciation (a non-funds item), the depreciation must be added back to net profit in order to determine the amount of funds actually provided from operations."

The question often arises from non-accounting circles as to why depreciation is not added back net of a tax credit. While the reason appears obvious, I found it was not generally known and may be of interest:

Where an item of cost such as depreciation is covered by an item of revenue, no profit and related tax result. Therefore, depreciation is added back gross rather than net after tax credit.

J. J. DAPICE, CPA
New Canaan, Conn.

Book Reviews

COST ACCOUNTING: ANALYSIS AND CONTROL

By Gordon Shillinglaw, Richard D. Irwin, Inc., Homewood, Ill., 1961. Pages: ix + 779; $10.65.

Though this book is a college text, it nevertheless has interest for accounting practitioners who seek to up-date their cost accounting reference library.

It is divided informally into five sections. Section One consists of largely introductory material discussing in four chapters "The Framework of Managerial Accounting"; "Budgetary Planning and Control"; "Income Measurement and Inventory Valuation" and "Patterns of Business Costs."

Section Two consists of eight chapters devoted to the costs of manufacturing. "Historical Cost Systems: Materials and Labor"; "Standard Costs for Materials and Labor"; "Accounting for Standard Costs: Labor and Materials"; "Flexible Budgets and the Control of Manufacturing Overhead Costs"; "Allocation of Manufacturing Overhead Costs"; "Absorbtion of Manufacturing Overhead Costs"; "Problems in Process Costing"; and "Joint Products and By-Products" are fluently discussed under the aforementioned chapter headings.

Section Three relates to overall financial planning, control and non-manufacturing costs. In three chapters are discussed: "Control of Non-Manufacturing Costs" and "Planning Budgets," the latter dealing with the preparation of the Annual Operating Budget, Production and Inventory Budgets, the Annual Profit Budget, the Annual Cash Budget and the Annual Capital Expenditure Budget.

Section Four discusses the elements of decision making in five chapters and an Appendix. "Quantitative Elements In Decision Making"; "Capital Expenditure Analysis"; "Incremental Profit and Profit-Volume Analysis"; "Variable Costing"; and "Product Pricing." The Appendix includes three tables dealing with 'present value' calculations and two 'future value' tabulations. The application and use of these tables as decision making aids is explained fully.

Section Five concerns itself with measuring profits of organizational divisions of decentralized companies, and of establishing standards for the evaluation of profit performance in such divisions. Internal Profit Reporting and Intracompany Transfer Pricing are discussed.

This textbook places emphasis on what managers need and want to know. The actual process of managing is a procedure whereby objectives are established, the attainment of the objectives is directed and the results thereof are measured. To accomplish its purpose, management must gather information, synthesize the information so that it can be utilized, plan, decide and organize itself for the use and communication of the information so that the same may serve the organization. Finally, having put the information gathered to use, management must evaluate, measure and control the use of the information so that most favorable results may be attained. "Cost Accounting Analysis and Control" by Professor Shillinglaw, will aid its "management-minded" students to accomplish these purposes of management.

SAMUEL S. RESS, CPA
NEW YORK, N. Y.

PRACTICAL CONTROLLERSHIP

By David R. Anderson and Leo A. Schmidt, RICHARD D. IRWIN, INC., Homewood, Ill., 1947 and 1961. Pages: vii + 777; $10.65.

Practical Controllership was written by David R. Anderson, CPA, a Controller, and Leo A. Schmidt, CPA, a Professor of Accounting. It combines theories for the student and practical ideas for the active Controller. The volume contains considerable material of interest for an executive in the Controller's division of a corporate enterprise. Since most professional Certified Public Accountants must deal with the Controller as his opposite in business, an examination of this volume was made in the light of its value to the practicing Certified Public Accountant.

For this purpose, let us first examine the structure of this large book. The text consists of three parts, the first of which consists of 5 chapters totaling 128 pages on Functions and Organization of the Controller and his Department. The second part, which is the real meat of the book, consists of 15 chapters and 320 pages on The Controller and the Basic Techniques. The third part, which could have been the best part of the book but was disappointing, comprised 6 chapters and 128 pages on The Controller and Forward Planning. In addition, there were 140 pages of problems and cases for the student and appendixes consisting of excerpts from the Chart of Accounts of three corporations, Capital Expenditures, Property Record Procedure, and Maintenance Control Accounting Procedure. It can be readily seen that this is a well rounded book and that the authors have in-

corporated a wealth of material between the two covers.

There are many reasons why the practicing CPA should have a copy in his library. The authors' appoach to the functions of the Controller is an interesting one which could be extremely helpful for any accountant who has the problem of assisting his client in the organization, or reorganization of a Controller's department. In addition to a complete discussion of the responsibilities and the functions of the Controller, there are several exhibits of organization charts based upon actual cases, from a small company to a major complex enterprise. The authors expose themselves to rebuttal regarding a chart which they call an ideal Controllers department organization.

In The Controller and the Basic Techniques, the authors start with the accounting plan and have included several suggested charts of accounts for different types of businesses. There

are examples of the cost structure, using as a case study a cotton cloth manufacturer. Several exhibits assist in understanding the points that the authors make.

A discussion of the various methods of inventory valuation should be required reading for the practicing CPA, for it suggests some of the practical business requirements from the viewpoint of the operating executive, indicating the impact of the method followed upon the financial statements and operating results.

The section on Reports to Management has some good ideas but is weak in that it does not include exhibits of the full range of operating and management type reports. It includes discussion of control reports, information reports and venture measurement reports, all of which are considered under the classification of Operating Reports. Under the caption, Financial Reports, the discussion has to do with static reports, principally relating to financial strength, and dynamic reports principally in the area of measurements of the effective use of funds and reports upon changes in financial condition. More emphasis is placed upon factory operating reports than any other reporting area.

In the section on Forward Planning, the authors describe the budget as "Basically, it is the planning in advance of all phases of business activity, together with a subsequent checking of actual performance against the plan as is necessary for its function." This is a broad assertion and much of the discussion that follows is keyed to this concept. However, while there are some practical examples, it would appear that this section could have been expanded further. The CPA cannot find too much to help him with establishing budget procedures and methods, but he will find theoretical discussions that could help him in arriving at a practical approach to problems that he may encounter in his practice.

There is sufficient material of practical value to the practicing CPA to warrant acquiring this volume and reading segments from time to time so as to refresh himself as to practical approaches to the solution of problems from a management viewpoint. If nothing else, this volume will help the CPA think in terms of "If I were the Controller, how would I handle this problem." With this point of view the CPA can become a more valuable professional advisor to his clients.

ADOLPH G. LURIE, CPA
New York, N. Y.

THE PRESIDENT'S PAGE

The Public Responsibilities of Businessmen and Accountants

Certified public accountants, as well as other professionals, have voluntarily placed themselves under the control of a code of professional conduct. Perhaps the major reason for this personal subordination is the sense of public responsibility that underlies professional activities.

Enlightened leaders in the world of business and finance are coming to the realization that, though the prime motivation of business is profit, nevertheless it is also tinged with public responsibility. This is particularly true in the case of public corporations, but it applies in no small measure to non-public businesses also.

However, the spread of the concept of public responsibility amongst owners and managers of public as well as private enterprises can and must be greatly speeded up.

Accountants, generally, are in a position to help in this process. Their status as advisers to businessmen makes it possible for them to discreetly and patiently exert influence in this direction. Moreover, as auditors having a responsibility to stockholders, creditors, tax departments, and other segments of our economic society, we have this further motivation.

Some business practices should be avoided entirely, because they are either illegal or widely open to abuse and misjudgment. In this area are mainly the practices which raise questions of conflict of interest. A few sensational disclosures have created a great disquiet about the probity of business managers and directors. Price-fixing violations by our most respected industrialists have also shocked the public and its political leaders.

Such actions can have the most drastic repercussions for business, if continued.

Other business practices, though basically sound, lend themselves to abuse by a small minority of reckless persons, and are prone to misjudgment by a poorly informed, suspicious public. In this realm are stock options, pension plans, deferred compensation plans, employment contracts and other employee-employer arrangements.

Stock options are an area in which the most careful and discriminating judgment should be exercised by those who recommend them for stockholder approval. Stock options do grant compensation at a low tax cost to the holder, and like pension plans, will often cause a valued officer to stay with his company rather than accept an otherwise attractive offer from a competitor. They are, however, discriminatory, for by their very nature they can be given only to a few employees. From the stockholder's viewpoint, stock options do, to some extent at least, dilute his equity. Moreover, when a stock rises in price, it is often debatable whether the rise is due to the general action of the market or to the profits attributable to an outstanding and unusually able management. If they are granted, it should be only after the most careful consideration of the real need, the reasonableness of the plan, and the fullest disclosure to stockholders.

American business and economic life has changed tremendously since the end of World War I. There has been a substantial growth in stock ownership, so that it is now estimated that there are in this country some 15,000,000 stockholders, one company alone having two million. With the growth of the large corporations, and the steady disappearance of the small personally owned and operated companies which have "gone public," there has come into being another group of business men—professional managers, men who are operating businesses owned by others. They are responsible to their stockholders for their conduct of the business and for the profits they earn, but they are also responsible to others for their actions—to labor, government, often even to the communities in which their factories operate.

It seems to me that management and corporate directors should not only recognize and accept these responsibilities, but that they should also set up for their own guidance a code of professional conduct, with adequate means for its enforcement. Such voluntary action will preclude possible governmental intervention and minimize demagogic criticism.

EDWARD J. BUEHLER,
President

Legal Dividend Sources—A National Survey and Critique

By STEPHEN A. ZEFF, PH. D.

This article constitutes a survey and critique of state dividend laws. A prodigious task, it presents the positions of all states and the District of Columbia (subject to conflicts arising from court decisions and ambiguities in statutes) as to recognized sources of dividends, restrictions on payments and notice requirements. Convenient reference tables supplement the article.

An awareness of the varying rules governing dividend payments is essential for accountants having clients in more than one state, inasmuch as they must pass on their classification in financial statements and on the adequacy of required disclosures.

The sources from which cash and other property dividends may be paid are prescribed by state law, and the dividend provisions of the 50 states and the District of Columbia (hereinafter referred to as a "state") vary considerably from each other in form and substance. Common sources are: "surplus," "earned surplus," and "net profits," and some states specify more than one source for each of different kinds of dividends.

It is the purpose of this paper to explore at some length as well as evaluate these divergencies, particularly in regard to the permissible sources for dividends that are allowed to pass as "ordinary dividends." So-called "dividends payable out of depletion," relative to wasting-asset corporations (sometimes called "consuming-asset corporations"), will not be included in the discussion. "Stock dividends" are also omitted. At the conclusion of the paper, the tax status of dividends will be treated. Reference will also be made to relevant pronouncements of the New York Stock Exchange, American Stock Exchange, and Securities and Exchange Commission.

Interstate operations are constantly expanding, as large and small companies branch out, merge, and diversify. Many small companies, in addition, are now "going public." They may choose any of several states in which to incorporate initially. Multi-corporation operations are common where tax and operating conditions make them expedient or economical. The managements and directors of these corporations, particularly of the public corporations, are constantly concerned with the payment of dividends. In profitable closed corporations, the federal tax penalty on unreasonable accumulations of undis-

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tributed profits exerts a significant pressure on dividend decisions.

Accountants, as financial advisors to clients, are often called upon to discuss and counsel on the amount and form of dividend distributions. They must therefore be aware of the dividend laws of the states in which their clients have domestic charters (and, to an increasing extent, also in states where they are foreign corporations).

Although an accountant must not presume to advise clients—as would a lawyer—on the meaning and import of dividend provisions, a general understanding of such provisions would enable the accountant to suggest the possible existence of a legal problem. Subsequent consultation with an attorney, furthermore, will be facilitated by the accountant's enhanced appreciation of the general shape of the law in question.

In many states the amount available for dividends may be determined by directors with immunity, if they act in good faith on the basis of financial statements prepared by certified public accountants. In such cases, accountants have an extra reason for maintaining a watchful eye on the dividend provisions of governing states.

Finally, accountants must view all distributions, regardless of their legality, in the light of sound accounting principles and disclosure standards. The disclosures required by Accounting Research Bulletin No. 46 ("Discontinuance of Dating Earned Surplus"), for example, must be made so that distributions that are not out of earnings since the quasi-reorganization are clearly identified. The terms of a directors' resolution do not of necessity fix the nature of the distribution for purposes of the financial statements. Numerous state laws, expressly or by implication, endorse looser disclosure standards than those advocated by the Institute.

DIFFERENT KINDS OF DIVIDENDS

Dividends may be classified into many different types.[1] In this paper, "dividend" will refer to distributions of cash, except where otherwise noted. The "source" of a dividend implies a specific accounting equity (e.g., earned surplus, capital surplus, net earnings) that is associated with the assets to be disbursed.

Two kinds of dividends will be studied: "ordinary" dividends and "notice" dividends. Ordinary dividends are those dividends that, in accord with applicable law, may be announced and paid as though they emanate from current or previously accumulated (but hitherto undistributed) earnings. Stockholders and the public generally interpret dividends as coming from earnings. Accordingly, the absence of a notification requirement specifying to the contrary creates the presumption of an ordinary dividend, regardless of what the true source may be. A notice dividend is a dividend that, in accord with applicable law, must be accompanied by notice to the effect that the source thereof is other than "earnings."

Some may contend that this twofold classification is neither desirable nor helpful.[2] They would argue that dividends should be categorized according to their true source (e.g., capital transferred to surplus), not according to that which, expressly or by implication, is represented (e.g., current earnings) as being the true source. This latter method of classification, one that is usually employed, overlooks the numerous other devices by which directors, often without effective notice to stockholders or to the public, may distribute corporate assets.

Quasi-reorganizations and recapitalizations may make available as legal dividend sources funds that presumably were committed enduringly to attainment of the corporate objective. The

acquisition and reissuance of treasury shares also permits such distributions. Hence, it appears to be too narrow to accept a classification of dividends according to what sources are available —relegating the matter of notice to inconsequential status. If the directors are sufficiently inquiring, they will generally find that a number of sources are available for some kind of distribution, often without a requirement that notice of the source be given. Further, a classification of dividends in accord with their manifest character, as seen by recipients and other interested parties, might impel lawmakers to protect affected third parties from the effects of potentially harmful acts of directors.

MAJOR OBJECTIVES OF DIVIDEND REGULATION

Traditionally, three major objectives of dividend regulation have been discernible:

1. To protect creditors from an unreasonable thinning of the corporate capitalization;
2. To protect the rights of the various classes of stockholders as among themselves; and
3. To protect stockholders and interested third parties from drawing improper inferences from such corporate distributions.

Recent legislation seems to have emphasized objectives (2) and (3) more so than was true during the nineteenth century and early decades of the twentieth century. Indeed, it appears that the first statute requiring notice of a dividend source was enacted as recently as 1927 (Ohio). Objective (2) aims to prevent directors from dissipating the assets beyond what is necessary to satisfy the liquidation preferences of certain classes of stockholders.

A fourth objective which has become prominent as a major factor since the promulgation in 1950 of the new Model Business Corporation Act (as revised),[3] purports to maintain the financial going-concern status of the corporation by not allowing directors to whittle away the stockholder-contributed investment in the absence of (1) authorization in the articles of incorporation, or (2) specific permission of the stockholders. Although at least one other provision of the Model Act seems to be at variance with that objective, the sense of the dividend sections is that directors should not be allowed to distribute in the normal course assets that are required to maintain stated capital and capital surplus. In Model Act states the latter source is available only for notice dividends, while in a number of Non-Model Act states (as will be shown below) capital surplus is a proper source for ordinary dividends.

JURISDICTIONS TO BE SURVEYED

The dividend laws of the 51 states are the subject of this paper. In several states (including Indiana, Iowa, Minnesota, and District of Columbia), where two alternative statutes are in use, only the more recent enactment is considered here.

In 1961, New York passed a new corporation law—that state's first corporation-law overhaul in over 30 years —that takes effect on April 1, 1963. Both the existing law, referred to herein as "New York (current)," and the new law, "New York (eff. 4/1/63", will be discussed. As a consequence, 52 laws are covered.

DEFINITIONS OF TERMS

Very few states adequately define the technical accounting and legal terms employed in their dividend sections. Because ultimate recourse must be made to the particular statute together with related case law for resource material on the definitions ap-

plicable to any one state, only a few rather broad definitions will be essayed here.

Legal Capital. Stated capital (the more modern term), capital, capital stock, and capital shares are terms that usually have the same meaning as does legal capital—the portion of stockholder-contributed funds that each statute circumscribes as more or less inviolate. The purpose of this legal buffer, viz., to provide a margin of safety for creditors, was more effectively served prior to the advent of no-par shares than it is today. Nevertheless, the concept of legal capital is a part of every state corporation law.

Surplus. Surplus, when not preceded by a qualifier, means the excess of net assets (= total stockholder investment) over stated capital. Capital surplus, roughly synonymous with paid-in surplus, usually connotes the same meaning at bar as that given it by accountants.

Earned Surplus. Earned surplus is sometimes "defined" in statutes as simply the excess of surplus over capital surplus, which is not a lucid authorization. Due to the influence of the Model Act, numerous states now have a qualitative definition of earned surplus, detailing its constituent parts instead of referring only to an excess. Some states, though they utilize the term in their dividend sections, do not define earned surplus in any way. This is also true for other accounting terms in a number of statutes.

Other Surplus. Surplus created from sources other than earnings is given varying titles such as capital surplus, appreciation surplus and revaluation surplus. Unless the source of such surplus is specified, its true nature may be misjudged. Some sources of other surpluses are: (1) capital stock sales at prices in excess of par or stated value (2) redemption of capital stock below par or stated value (3) the legal reduction of the par or stated value of capital stock and (4) appreciation in the value of property, equipment, and even marketable securities.

Among the more unsatisfactorily used terms are: net profits, profits, net income, net earnings, and—the most perplexing of the lot—surplus profits. Not only does no statute define any of these terms, but also no state outlines, or otherwise refers to, a mandatory set of practical standards according to which the terms may be put to use. Although one or more of these five terms are found in the corporation laws of a large majority of states, many of the states offer no clue as to *any* criteria that may safely be employed in their use. These terms will be reintroduced below.

LIMITATIONS ON DIVIDENDS

Dividend provisions may contain, in addition to references to sources such as surplus and net earnings, general limitations applicable in insolvency circumstances. "Insolvency" may mean (1) inability to meet debts as they mature, or (2) a situation where liabilities exceed assets. The former is usually termed "equity insolvency," and the latter, "bankruptcy insolvency." Although every statute does not expressly forbid dividend payments in time of insolvency, each state presumably has a body of law, contained in statute form or developed as common law, covering creditors' remedies in cases of conveyances by a debtor that would cause the latter to be insolvent in either or both senses of that term. Indeed, 21 states have adopted the Uniform Fraudulent Conveyances Act, which has a definition of insolvency that contains both "equity" and "bankruptcy" features.

CURRENT TRENDS IN DIVIDEND LEGISLATION

Eighteen states have made important changes in their dividend laws during the last decade. And since 1927, the great majority of dividend laws have been revised at least once. Two divergent trends are evident:

1. LIBERAL: Permitting ordinary dividends to be paid out of current net earnings notwithstanding an existing impairment in stated capital; alternative sources, such as surplus or earned surplus, are also provided.
2. CONSERVATIVE: Permitting ordinary dividends to be paid only from unreserved and unrestricted earned surplus.

(Admittedly, this dichotomy is somewhat of an oversimplification, but it will assist in describing the general shape of the developing law.)

The liberal trend originated in this country with the Delaware act of 1927 (and amended in 1929). Other states have joined as follows:

1931	California	1947	Oklahoma
1933	Minnesota	1949	Nevada
1938	Georgia	1955	North Carolina
1939	Kansas		
1941	Montana	1961	Wyoming
	Nebraska		

Aside from the states that have adopted the dividend language of the Model Act (which espouses the conservative philosophy), nine states, using Non-Model Act language, also represent the conservative side. They have joined as follows:[4]

1927	Ohio (revised in 1931)	1946	Missouri
		1951	Maryland
		1954	District of Columbia
1928	Louisiana		
1933	Illinois	1961	New York (eff. 4/1/63)
1937	Hawaii		
1943	Michigan		

The Model Act, first published in 1946 and since revised four times, was conceived by the Committee on Corporate Laws of the American Bar Association.[5] Ostensibly, it was designed to replace the Uniform Business Corporation Act (first published in 1928), which was developed by the Commissioners on Uniform State Laws. The Uniform Act was retitled "Model Business Corporation Act" in the late 1930s, and was withdrawn from active sponsorship by the Commissioners in 1957 after only four states (Idaho, Kentucky, Louisiana, and Washington) had accepted appreciable portions of it. Only Idaho, Louisiana, and Washington have dividend provisions today that conform substantially to the Uniform Act.

During its brief history, the Model Act has been utilized in many states as the basis for overall revision of corporation statutes. Eleven states[6] have embraced most of the salient features of the Model Act as a result of their wholesale revisions. The Act was an influential factor in the general revision of corporation statutes in Alabama, Maryland, North Carolina, and Connecticut, and in the reformulation of the capital and surplus provisions in Pennsylvania. As a consequence, 10 states currently use the Model Act conception of, and language for, an ordinary dividend—adopted in the following order:

1951	Wisconsin	1957	Alaska
1953	Oregon		North Dakota
1955	Texas		Pennsylvania
1956	Virginia	1959	Alabama
			Connecticut
		1961	Utah

Of these, only Alabama makes no provision whatever for notice dividends.

Thus, 19 states, by statute, have adopted the conservative philosophy

and 11 states the liberal philosophy. Of the remaining 22 states, 11 specify surplus as the source of ordinary dividends; nine states ambiguously refer to "surplus or net profits" (or the like), suggesting the possible application of the current-net-earnings test; and two are mavericks.

"CURRENT-NET-EARNINGS" STATES

The most complex dividend sections of all are found in the statutes of these 11 states—particularly in that of North Carolina. Table A summarizes the principal features of the 11 laws. They provide that an ordinary dividend may be paid from current net earnings notwithstanding the absence of any surplus or existence of a capital impairment. Some have called such a distribution, a "nimble dividend."[7]

Generally, the statutes provide for one or more sources in addition to current net earnings. That the latter term is nowhere defined in the 11 statutes is probably commendable, for accountants have learned from decades of experience that a precise and correct calculation of the periodic net income of a going concern is a practical impossibility.

In place of such a definition, the states usually allow directors to escape liability if they rely in good faith on the representations of certain other parties. North Carolina and Wyoming protect directors who rely in good faith on financial statements that have the approval of certified public accountants or of the corporation's officers. Minnesota and Oklahoma require that, if the directors desire to rely (in good faith) on financial statements that have been passed upon by "public accountants," such statements must be "certified to be correct"(!). Delaware, Georgia, Nebraska, and Nevada are the kindest to directors, permitting them to rely in good faith on the statements made by any of the corporation's officials as to all relevant financial information.

It would seem that a better approach is for a statute to handle the determination of net earnings as would the certified public accountant (i.e., look to the pronouncements issued under the auspices of the American Institute of Certified Public Accountants),[8] allowing directors to depart therefrom only if (1) they choose an alternative that would appeal to reasonable and prudent men in similar circumstances and (2) notice of the nature of the departure from *reported* net earnings is disclosed to (at least) stockholders.

Communication Problems. Stockholders. other interested parties, and directors should all be talking the same language. If financial reports are issued in accord with generally accepted accounting principles, a concurrently—or subsequently-declared dividend—not accompanied by representations to the contrary—will be interpreted by recipients thereof as well as others as coming from current or previously-accumulated *reported* net earnings. As long as (1) the general public understands ordinary dividends to be distributions of earnings,[9] and (2) external financial reports are subject to the examination of certified public accountants, the presumption that ordinary dividends emanate from earnings determined in accord with generally accepted accounting principles will remain. The use of multiple standards for the determination of key accounting figures, unless the several methods of calculation are given full and fair disclosure, will serve only to confuse and mislead.

Only North Carolina and Oklahoma[10] require that notice accompany dividends paid from current net earnings, but what is to prevent the directors, acting within the letter but not

the spirit of the law, from labeling the source as "net earnings"—with no further comment? If such a notice satisfies the legal requirement, the dividend becomes in reality an ordinary dividend. Neither state provides that the notice contain a full representation of all material facts.

Ordinary Dividends From Capital Allowed. For a corporation having only one class of stock, an ordinary dividend from current net earnings—so long as it does not run afoul of other applicable dividend limitations (e.g., equity insolvency)—may leave in its wake a fully depleted stated capital. For a corporation having more than a single class of stock, at least one of which possesses a liquidation preference, an ordinary dividend from current net earnings—again, in the absence of other limitations—may be paid except where the remaining stated capital would be less than the total liquidation preferences, except in California and Minnesota, where such dividends may leave even a lesser balance but only if the dividends are paid to the stockholders who have the liquidation preference. In each instance, it should be noted, the dividend is an *ordinary* dividend.

Although the 11 'current-net-earnings' states permit what amount to ordinary dividends in the presence of a capital impairment, the laws of most other states apparently allow ordinary dividends that have a similar effect—but by less direct means. In states whose most restrictive dividend test is that of capital impairment, a surplus created by recapitalization is usually either expressly or impliedly available for ordinary dividends. In earned-surplus as well as capital-impairment states, earned surplus that has accumulated since the date of quasi-reorganization is available for ordinary dividends. But it should be noted that disclosure and/or a special stockholder vote[11] may be required to effect either the recapitalization or quasi-reorganization. Because of the publicity that would—indeed, should—usually attend such actions, these approaches seem prefereable to the current-net-earnings test, as it is presently used.[12]

But it is apparently the intent of the current-net-earnings states that the capital impairment should be viewed as temporary. The draftsman of the Minnesota statute writes:

> ". . . it seemed to the committee [on formulating the Minnesota Business Corporation Act] that the corporation's management should be permitted gradually to restore the stated capital out of earnings over a period of years, rather than be required to choose immediately between the declaration of no dividends and the reduction of the stated capital."[13]

After one or two bad earnings years, the corporation should not be consigned to an extended period of dividend drought solely because of an inflexible statutory provision. Such a strait-jacket might preclude the additional financing that is necessary to the firm's survival. This argument is persuasive, although 10 of the 11 states make no provision for the lost capital ever to be restored. Only Oklahoma requires that no more than one-half of any year's net earnings may be so available for dividends.

Notwithstanding the reasonableness of this dividend test in certain situations, such a distribution should not be described as coming from net earnings. The division by the accountant of a firm's economic life into one-year periods should not be allowed to obscure the fact that the enterprise has a past and a future. If owners have endowed a corporation with a given amount of invested funds, it should be assumed that the owners intend that

the corporation employ these funds for its business purpose. If the corporation loses half of the invested funds in its first year, requiring the next five years to recoup this loss (via annual "net earnings"), a return to stockholders during those five years of "net earnings" *qua net earnings* is a misleading act. The tree has borne no fruit; a wound has only been repaired. Yet 11 states would seem to allow directors to declare dividends with no promulgation of the attendant facts. Notice of the true source together with a statement of the circumstances that surround the dividend declaration should be required in each of the 11 states.

It is also recommended that these states provide, as does Oklahoma, that a certain portion (at least half) of net earnings reported in a year in which a capital impairment exists be excluded from the funds available for ordinary dividends.[14]

It should be observed that these states have exalted the protection of the rights of stockholders *inter sese* over the protection of creditors—the latter having been the major consideration implicit in dividend laws since the early nineteenth centry. Indeed, creditors may need the *most* protection at a time when capital is already partially impaired. California and Minnesota, allowing dividends (without notice!) to preferred stockholders even when the capital associated with the preferred shares is impaired, invite irresponsibility toward the handling of creditors' claims. And for corporations that do not have substantial layers of preferred stock, all 11 states come close to disregarding the interests of creditors.

STATES BORDERING ON THE CURRENT-NET-EARNINGS TEST

In addition to the 11 states that unambiguously permit ordinary dividends out of current net earnings notwithstanding an existing impairment in stated capital, the statutes of nine other states would appear to come within a breath of doing likewise. Indeed, federal courts have construed the "surplus or net earnings" provisions (since repealed) of two states—plus the presently-existing like provision of another state—as conforming to the Delaware-type current-net-earnings test.

Together with the phrases quoted in Table B, the nine states provide that directors may not by such act "withdraw," "divide," "decrease," or pay out stated capital. None of these statutes stipulates, however, that such a dividend may not be paid in the presence of an *already-existing* capital impairment. A distribution from current net earnings in such a circumstance might be interpreted at bar as not coming from capital, although as a financial reality it is from capital.[15]

Because of court construction, New Jersey can apparently be omitted from this category and classified instead as an earned-surplus state. In the 1949 New Jersey case of *Dohme v. Pacific Coast Co.,* the court said:

> "Controlling cases in this state construing [the dividend provision of New Jersey] . . . confine the source to earned surplus funds."[16]

Furthermore, in the light of a comment in a 1932 decision of the Supreme Court of New Mexico,[17] which borrowed its dividend provision from New Jersey, that state might follow New Jersey into the earned-surplus category.

Lack or Vagueness of Definitions. The phrase "surplus or net profits" may be variously interpreted. Are two different sources intended? Ballantine and Hills think not.[18] But there is reason to question this conclusion. The answer depends on the meaning of the terms "surplus" and "net profits." And

is "surplus or net profits" the equivalent of "surplus or net earnings?"

An examination of corporation statutes, court decisions, and law-review articles indicates that there are no settled meanings at bar for several key accounting terms. Until the mid-1930s, it was a rarity to find a statute that defined the accounting terms that it employed. In recent years, however, lawmakers have attended more to defining technical words in their corporation statutes, although the definitions are not always helpful. The vacillation by accountants over terminology has undoubtedly contributed substantially to this situation.

Certain generalizations as to terminology can be made, but, like so many generalizations, they may not apply in more than a bare majority of the cases. Whereas an accountant would equate the terms "net profits," "net earnings," "earnings," and "net income," they are not usually recognized as the same at bar. "Net earnings" is typically used by the courts to mean *periodic* net earnings, while "net profits" and "profits" are often interpreted as meaning either surplus or earned surplus.[19] It is therefore significant that the laws of Arkansas, Florida, and Tennessee employ "net earnings," not "net profits."[20]

As already noted, three federal courts interpreted "surplus or net earnings" provisions to be tantamount to the current-net-earnings test. The states involved were Virginia,[21] Michigan,[22] and Tennessee.[23] The Tennessee provision is still extant, but the federal decision, although it will carry considerable weight in Tennessee, is not controlling in that state. Presumably, the *Brooks* principle can be applied to the similar provisions of Arkansas[24] and Florida.[25] The provisions of Indiana, Rhode Island, South Carolina, and West Virginia—because they avoid the term "net earnings"—would appear to be less likely to be so construed. But the way is open for a court to conclude that alternative sources are intended (as opposed to two or more descriptions of *one* source), and then for the court to determine what is meant by "net profits," or wording having similar effect. Although it may be argued that the usual judicial distinction between net earnings and net profits would protect these four states, it must be recalled that this distinction is hardly unanimous. It would be desirable for the legislatures of these states to remove the potential ambiguity.

Indeed, one writer refers to the curious Indiana phrase (quoted in Table B) as "a seemingly meaningless provision."[26] A further examination of the Indiana corporation law discloses that "surplus paid in cash" is to mean the excess of stated capital paid in, whether in cash *or property*. If this misnomer is interpreted as setting the standard for the precision with which terms are selected in the Indiana law, what is to be inferred from the undefined "surplus earnings" and "net profits?"

EDITOR'S NOTE: Because of its considerable length this article could not be published in full in one issue. The remainder of the article will appear in the next issue.

TABLE A

A SUMMARY OF THE DIVIDEND PROVISIONS OF THE 'CURRENT-NET-EARNINGS' STATES

SOURCES: as indicated.

LIMITATIONS: (1) a dividend will not be permitted from current net earnings if its payment would lower the remaining net assets below the amount payable on liquidation to shares having a liquidation preference; (2) other limitations as indicated.

STATE	ALTERNATIVE SOURCES	DURATION AND PROXIMITY OF PERIOD(S) DURING WHICH NET EARNINGS (OR NET PROFITS) ARE A PROPER SOURCE	LIMITATIONS OTHER THAN THE ABOVE
CALIFORNIA	earned surplus		
	net profits	preceding accounting period, no less than 6 months nor no more than one year in duration	If net assets will be thereby made less than the aggregate stated capital of shares having a liquidation preference, dividends from this source may be paid only to these shares until the deficiency has been repaired.
	reduction surplus or paid-in surplus		(1) If there are shares having a dividend preference, only to those shares; and (2) notice.
	LIMITATIONS ON ALL DIVIDENDS: (1) bankruptcy and equity insolvency. (2) appreciation surplus is not a proper source.		
DELAWARE	Net assets in excess of capital		
	if no excess, out of net profits	during the fiscal year then current and/or the preceding fiscal year.	
GEORGIA	Net assets in excess of capital stock		
	if no excess, out of net profits	(Same as DELAWARE)	
KANSAS	Net assets in ex- of net profits		
		during the fiscal year then current or the preceding fiscal years. (sic)	

TABLE A (Continued)

MINNESOTA	earned surplus		Does not include appreciation surplus.
	paid-in surplus		(1) If there are shares having a dividend preference, only to those shares; (2) notice; and (3) Does not include appreciation surplus.
	net earnings	during the current or preceding fiscal year.	(1) If the "fair value" of the assets would become, as a result of the payment of a dividend from this source, less than the sum of its liabilities and stated capital represented by shares having a liquidation preference, a dividend from this source may be paid only to those shares. (Unrealized appreciation of inventories and fixed assets is excluded from "fair value.") (2) bankruptcy insolvency.
MONTANA	excess of net assets over capital		
	if no excess, out of net profits	(Same as DELAWARE)	
	LIMITATION ON ALL DIVIDENDS: Payable only from "surplus profits" (undefined in statute)		
NEBRASKA	excess of net assets over capital		
	if no excess, out of net profits	during the fiscal year then current or the current and preceding fiscal year. (sic)	
NEVADA	excess of assets over liabilities, including capital		
	if no excess, out of net profits	during the fiscal year then current and the preceding fiscal year, or during the preceding fiscal year alone.	

TABLE A (Continued)

NORTH CAROLINA	earned surplus		(1) notice, if a deficit has been removed within one year previous. (2) Excludes appreciation surplus.
	net profits	during the current or preceding accounting period, each period to be not less than 6 months nor more than one year in duration.	(1) Regardless of any impairment of stated capital. (2) notice of source.
	if neither earned surplus nor net profits is available, out of capital surplus		(1) Only to shares entitled to preferential dividends. (2) Capital surplus paid in by one class of stock may not be used for dividends on any class junior thereto. (3) notice of source.
	LIMITATIONS ON ALL DIVIDENDS: (1) bankruptcy and equity insolvency. (2) dividend not permitted if, thereafter, "present fair value" of assets is less than twice the amount of liabilities. (3) dividend not permitted if, after its payment, "the highest aggregate liquidation preferences of shares entitled to such preference over the shares receiving the dividend would exceed the corporation's net assets."		
OKLAHOMA	earned surplus		
	paid-in surplus		(1) Only on shares entitled to a dividend preference or liquidation preference. (2) notice
	while impairment of stated capital exists, out of one-half of the net profits	(Same as CALIFORNIA)	(1) If there are outstanding both shares having a liquidation preference and shares having a dividend preference, a dividend from this source may be paid only to the latter. (2) No dividend from this source may be paid if, thereafter, the "value" of the net assets is not equal to the "highest aggregate amount of liquidation preference of all shares then outstanding having a liquidation preference, if any," plus one-half of the difference between said aggregate liquidation preference and the total stated capital—when the latter is the larger of the two. (3) notice

TABLE A (Continued)

OKLAHOMA (Cont'd.)	LIMITATIONS ON ALL DIVIDENDS: (1) bankruptcy (apparently) and equity insolvency. (2) dividend not permitted if, thereafter, net assets would not exceed one-fourth of its liabilities.		
	unreserved earned surplus		
WYOMING	net profits	(Same as CALIFORNIA)	
	capital surplus		(1) if there is no earned surplus. (2) only to preferred shares in satisfaction of their cumulative dividend rights.
	LIMITATION ON ALL DIVIDENDS: Equity insolvency.		

TABLE B

EXCERPTS FROM DIVIDEND PROVISIONS OF STATES THAT MIGHT POSSIBLY EMBRACE THE CURRENT-NET-EARNINGS TEST

Arkansas:

"net earnings, or from the surplus of its assets over its liabilities including capital"

Florida:

"net earnings or from the surplus of the assets over the liabilities including capital"
(limitation: undefined insolvency)

Indiana:

"surplus earnings or net profits or surplus paid in cash"
(limitations: undefined insolvency; may not be paid out of appreciation surplus)

New Jersey:

"surplus [including reduction surplus] . . . or from the net profits arising from the business"

New Mexico:

par shares: "surplus or net profits arising from [the] business"
no-par shares: "net profits or surplus earnings"

Rhode Island:

"surplus or net profits"

South Carolina:

dividends must "have been actually earned, or . . . paid out of surplus theretofore earned"

Tennessee:

"net earnings or from the surplus of its liabilities including capital"

West Virginia:

"net profits or any surplus arising from a reduction of capital"
(limitation: undefined insolvency)

REFERENCES

1. For historical data on the subject of dividends, consult Donald Kehl, *Corporate Dividends* (New York: The Ronald Press Company, 1941); Prosper Reiter, *Profits, Dividends and the Law* (New York: The Ronald Press Company, 1926); Joseph L. Weiner, "Theory of Anglo-American Dividend Law," 28 *Columbia Law Review* 1046 (December, 1928); Joseph L. Weiner, "Theory of American Dividend Law: American Statutes and Cases," 29 *Columbia Law Review* 461 (April, 1929); Joseph L. Weiner, "The Amount Available for Dividends Where No-Par Shares Have Been Issued," 29 *Columbia Law Review* 906 (November, 1929); Joseph L. Weiner and James C. Bonbright, "Theory of Anglo-American Dividend Law; Surplus and Profits," 30 *Columbia Law Review* 330 (March, 1930) and 954 (November, 1930).

Also see George S. Hills, *The Law of Accounting and Financial Statements* (Boston: Little, Brown and Company, 1957), chaps. 1, 4, and 5.

2. For a recent tabular summary of state dividend sources, see the comparatively brief article, Harry Buttimer, "Dividends and the Law," 36 *The Accounting Review* 434 (July, 1961). Buttimer chooses to ignore entirely the distinction between ordinary dividends and notice dividends, making no reference to required disclosures. Some discussion is directed toward so-called "depletion dividends" in wasting-asset corporations.

3. For the text of the Model Act, together with numerous case notes and state-by-state comparisons, see the new and very useful work, *Model Business Corporation Act Annotated* (3 vols.; St. Paul, Minn.; West Publishing Co., 1960); biennial supplements are planned.

4. As is noted below, New Jersey, by a 1949 court decision, seems to have become an earned-surplus state. *Dohme v. Pacific Coast Co.*, 68 A.2d 490, 497, 498. New Mexico might follow New Jersey in this respect.

5. For background information, including some discussion of the philosophy of the Act, see Ray Garrett, "History, Purpose and Summary of the Model Business Corporation Act," 6 *The Business Lawyer* 1 (November, 1950). For discussion of the financial provisions of the Act, see Ray Garrett, "Capital and Surplus under the New Corporation Statutes," 23 *Law and Contemporary Problems* 239, esp. 242 (Spring, 1958); George C. Seward, "Earned Surplus—Its Meaning and Use in the Model Business Corporation Act," 38 *Virginia Law Review* 435 (May, 1952); and William P. Hackney, "The Financial Provisions of the Model Business Corporation Act," 70 *Harvard Law Review* 1357 (June, 1957).

6. Chronologically: Wisconsin, Oregon, District of Columbia, Texas, Virginia, North Dakota, Alaska, Colorado, Iowa, Utah, and Wyoming. Of these, Colorado and Wyoming departed significantly from the Model Act concept of an ordinary dividend. Others, notably Texas and Virginia, strayed some distance from the Model Act concept of a notice dividend. These disparities are discussed below.

7. The term seems to have been first used by Professor Ralph J. Baker, of Harvard Law School. See 62 *Harvard Law Review* 130 (November, 1948); E. Merrick Dodd and Ralph J. Baker, *Cases and Materials on Corporations* (Brooklyn: The Foundation Press, Inc., 1951), pp. 1157, 1162; and Arthur M. Kriedmann, "Dividends—Changing Patterns," 57 *Columbia Law Review* 372, 374 (March, 1957). For a more extended discussion of this kind of dividend, including excerpts from the dividend provisions of the states, see Eleanor McCormick, "Nimble Dividends: Some States Do Permit Dividends Despite Deficit in Accumulated Earnings," 88 *The Journal of Accountancy* 196 (September, 1949). McCormick's title understates the nature of the extreme circumstances in which these states nonetheless permit ordinary dividends. It should read, "... Despite Deficit in Stated Capital."

8. For a somewhat parallel argument, see A. C. Littleton, "Business Profits as a Legal Basis for Dividends," 16 *Harvard Business Review* 51, 60-61 (Autumn, 1937).

9. In this paper, "earnings" is used interchangeably with "net earnings."

10. North Carolina provides that the source be disclosed, while Oklahoma calls only for "notice."

11. Many statutes permit such actions without either public notice (including notice to stockholders) or stockholder approval.

12. For a criticism of the current-net-earnings test, see Charles R. McDowell, "The Theory of Capital in Virginia: An Historical Comma and a Disjunctive Conjunction," 6 *Washington & Lee Law Review* 35, 38, 44-46 (1949).

13. Comments by Harvey Hoshour, "Payment of Dividends," 20 Minn. Stat. Ann., 196.

14. See Ballantine's suggested safeguards for the current-net-earnings test. Henry Winthrop Ballantine, *Ballantine on Corporations* (rev. ed.; Chicago; Callaghan and Company, 1946), p. 582. Regrettably, the states at which these reforms are directed are probably just the ones that would disdain them—because they want to attract incorporators.

15. ". . . [to] interpret a dividend, paid when there is an operating deficit, as a distribution of profits is an accounting absurdity." Henry Rand Hatfield, *Surplus and Dividends* (Cambridge: Harvard University Press, 1947), p. 28.
If capital is not whole, any distribution to owners made during the period of impairment is patently a return of that part of the capital which, according to the balance sheet, has left the enterprise. Net earnings (= Hatfield's "profits") represents an asset-layer erected upon a foundation of stockholder-contributed funds. In the absence of a "fresh start," or quasi-reorganization, the foundation must remain whole in order to support the superimposed asset layer. Any erosion of the former cannot occur until the latter has disappeared. See discussion on this point, above.

16. 5 N. J. Super. 477, 68 A.2d 490, 495. See also pp. 497-98.

17. *Cartwright v. Albuquerque Hotel Co.*, 36 N.M. 189, 11 P.2d 261, 262.

18. H. W. Ballantine and George S. Hills, "Corporate Capital and Restrictions upon Dividends," 10 *The Accounting Review* 246, 257 (September, 1935). The same article appeared under the title "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws" at 23 *California Law Review* 229 (March, 1935).

19. The following general references may be consulted on these points: Kehl, *op. cit.*, pp. 55-64; Ballantine, *op. cit.*, pp. 574, 575, 580-84; Hackney, *op. cit.*, pp. 1363-71; Weiner and Bonbright, *op. cit.*, pp. 331-37; and Kriedmann, *op. cit.*, pp. 373-74. A relatively recent federal case supports the view that "net earnings" (as opposed to "net profits") implies annual net earnings. *Grand Traverse Hotel Co. v. United States*, 79 F.Supp. 860, 867, 868 and note 4 (which cites numerous writers) (W.D.Mich. 1948). Nevertheless, another federal court uses "accumulated earnings" to mean the excess of assets over liabilities including capital. *Brooks Equipment & Mfg. Co. v. United States* 95 F.Supp. 247, 248 (Ct. of Claims 1951). See also the cases cited under "Net Earnings," "Net Profits," and "Profits" in *Words and Phrases* (perm. ed., 45 vols; St. Paul, Minn.; West Publishing Co., 1955) and pocket supplements.

20. It is notable that a federal district court, construing the present New Jersey dividend provision, decided that it did *not* allow dividends from current net earnings in the face of a capital impairment. The court said:

> "It is a prerequisite to the existence of net profits that the assets of a corporation exceed the liabilities, including the liability on the capital stock. . . . The term net profits is not synonymous with the term annual net earnings." *Lich v. United States Rubber Co.*, 39 F.Supp. 675, 681 (D.N.J.) *aff'd*, 123 F.2d 145, (3rd Cir. 1941).

Net profits, the *Lich* court said, are the

> ". . clear pecuniary gain remaining after deducting from the gross earnings of the business the expenses incurred in its conduct, the losses sustained in its prosecution, and the capital invested." 39 F.Supp. at 681.

For a later case that agrees, see *Mengel Co. v. Glenn*, 50 F.Supp. 765, 769 (W.D. Ky. 1943), *aff'd*, 145 F.2d 235 (6th Cir. 1944). See also Hills, *op. cit.*, pp. 172-76.

21. *United States v. Riely*, 169 F.2d 542 (4th Cir. 1948), *cert. denied*, 335 U.S. 908 (1949). Virginia eliminated the provision in 1956. For comments, see McDowell, *op. cit.;* 62 *Harvard Law Review* 130 (November, 1948); 10 *Ohio State Law Journal* 255 (Spring, 1949); and 34 *Virginia Law Review* 860 (October, 1948).

22. *Grand Traverse Hotel Co. v. United States*, 79 F.Supp. 860 (W.D.Mich. 1948). Michigan eliminated "net earnings" in 1943.

23. *Brooks Equipment & Mfg. Co. v. United States*, 95 F.Supp. 247 (Ct. of Claims 1951). For comments, see 23 *Tennessee Law Review* 769 (February, 1955).
It is significant that the *Riely, Grand Traverse Hotel*, and *Brooks* cases dealt with "surplus or net earnings" clauses, while the *Lich* case (see note 20), which contains the opposite conclusion, dealt with a "surplus or net profits" clause.

24. For agreement, see Harry Meek, "Changes Needed in the Present Arkansas Corporation Act," 10 *Arkansas Law Review* 1, 10 (Winter, 1955-56).

25. For further discussion of this point, see 12 *Florida Law Review* (Spring, 1959).

26. Hackney, *op. cit.*, p. 1361 at note 34.

Tax Rulings Procedure and Practice

By ALBERT A. RETTIG, LL.M.

Prediction of the tax consequences of a transaction (never an exact science) and high tax rates make taxpayers' rulings an important aid to the tax practitioner. The opportunity of knowing, in advance, the position of the Internal Revenue Service obviously is of vital importance to the efficient and economic solution of tax problems. Similarly, it is often desirable to obtain the opinion of the Service upon a recently consummated transaction in order that the taxpayer may know how to report it on his return.

Almost since the inception of the Internal Revenue laws, the Treasury has recognized the necessity of establishing some procedure whereby taxpayers, or taxpayers' representatives, could ascertain in advance of a contemplated transaction, or after a transaction has been closed but prior to filing the return, what would be the attitude of the Commissioner toward the tax aspects of such transaction.

Although tax rulings are now a major instrument for determining answers to tax questions, it is interesting to note that such procedures and practices have developed almost entirely without statutory mandate or formal rules. For many years, such practice was comprehended by relatively few Service representatives and experienced practitioners. However, effective May 24, 1954, the practice and procedure of tax rulings has been considerably clarified by the Commissioner in Revenue Ruling 54-172 (CB1954-1,394) and in 1955 by the Statement of Procedural Rules, Internal Revenue Practice. (CB1955-2,944). As a result, taxpayers are in a better position to know with reasonable certainty when the Commissioner will likely rule and the method by which a ruling is to be obtained.

Actually, there is a great similarity between the reasons why taxpayers request rulings and the reasons why the Government issues rulings. Both stem from a desire to reduce any potential controversy about the tax consequences of transactions. The benefits that tax rulings serve as part of the tax administration has been stated as follows:

(1) "to make it easier for taxpayers to compute their taxes correctly in the first instance and thereby to promote voluntary compliance;

(2) to lay the groundwork for fair and economical tax administration by placing within the knowledge of both taxpayers and examining officers principles to be applied in the enforcement of tax laws and in

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the settlement of disputes; and
(3) to provide certainty as an aid to business and other elements of our economy upon the normal activity of which the tax system is dependent."*

DEFINITIONS

Revenue Ruling. A "revenue ruling" is a written statement issued by the National Office of the Internal Revenue expressing an official interpretation or policy and application of substantive tax law as to the tax effects of certain acts or transactions. In its simplest terms it is the letter which the Internal Revenue Service writes to a taxpayer in response to the taxpayer's letter asking how a particular item or event will be treated for tax purposes.

The more general the inquiry the less likely it can be treated as a basis for a binding answer by the Service. Only those inquiries which seek a determination of, or a specific statement of, the Revenue Service's position as to the tax consequences of a specifically described transaction are likely to be regarded as requests for rulings.

The terms "private rulings" or "special rulings" have frequently been used in various tax periodicals and services, but have no particular significance in terms of the practice of the Internal Revenue Service in issuing rulings. The procedure for securing rulings are available to all taxpayers.

Determination Letter. A "determination letter" is a written statement issued by a District Director of Internal Revenue in response to an inquiry by a taxpayer involving a completed transaction. Determination letters may be issued by a District Director only where a determination of tax liability or tax consequences can be made on the basis of clearly established rules specifically set forth in the statute, Treasury decisions or Regulations, Revenue Rulings, or opinions or court decisions published in the Internal Revenue Bulletin. Determination letters generally are issued only on routine matters, whereas rulings establish policies and principles as well as interpretations of the law in particular cases.

Closing Agreements. A "closing agreement" is a formal ruling, which is authorized and made binding on the parties pursuant to Code Section 7121. Actually, these are a more formal expression of the tax consequences of a future specific transaction. In practice, closing agreements are the exception rather than the rule, since only a negligible number of taxpayers rulings are formalized by closing agreements.

Published Rulings. Published rulings are derived from ruling letters and closing agreements and differ from them in the sense that they are published as general tax rules for the guidance and information of all taxpayers other than the taxpayer to whom the original ruling letter or closing agreement was mailed. They are published as "revenue rulings" in the weekly Internal Revenue Bulletin. Published rulings, as issued by the National Office, usually deal with substantive tax law, procedures directly affecting taxpayers' basic rights and duties, or industry-wide regulations.

LIMITS ON ISSUANCE OF RULINGS AND DETERMINATION LETTERS

Except where the Internal Revenue Code or Regulations thereunder require a prior determination, the issuance of a ruling is discretionary. These restrictions are derived from limitations within the Revenue Service based on practical considerations and policy. The situations in which the

* See Sugarman, "Federal Tax Ruling Procedure," 10 Tax Law Review 1 (1954).

Service will *not* rule in advance are as follows:

Past Years. Rulings will not be issued where the question involved is present in a return or returns already filed by the particular taxpayer. The Internal Revenue Service considers that these matters are proper subject for field audit and it will not rule on a matter already under the jurisdiction of the District Director's Office. If the matter is one in which the advice of the National Office is needed, there is procedure for the District Director requesting advice of the National Office.

Hypothetical Cases. As a general rule, the Internal Revenue Service will not issue a ruling unless there is an actual case involving a named taxpayer. In other words, it will not rule in hypothetical cases where there is no real transaction which is pending or proposed with respect to which advice is needed.

Transactions of Indefinite Date. The Revenue Service will not rule on any request when it is clear that the event in question is not intended to take place in the near future.

Factual Matters. Rulings are not issued where the question is principally a factual one. The Statement of Procedural Rules contains examples of factual areas in which the Commissioner will not issue rulings. Five specific categories are listed: (a) determination of the market value of property, (b) whether compensation is reasonable in amount, (c) whether a transfer is one in contemplation of death, (d) whether there has been an unreasonable retention of earnings, and (e) whether a transfer or acquisition falls within Section 1551. To these categories, other factual situations can be added. In this connection, the Internal Revenue Service recently published a detailed listing of those areas in the 1954 Code wherein it will not issue advance rulings and determination letters because of the inherently factual nature of the problems involved. (Rev. Proc. 60-6, CB1960-1,880)

Policy Matters. The final area of nonissuance of rulings involves situations in which the Service, for administrative reasons, feels it best not to commit itself on particular transactions. Where there are conflicting court decisions, the Service may feel it cannot rule until the issue is resolved. Moreover, the Service may decline to rule where the request for a ruling appears to involve a tax avoidance device or "tax gimmick." In addition, the issuance of rulings generally must await the promulgation of governing regulations.

Although there is a broad group of policy matters upon which rulings will not be issued, its composition constantly changes as the courts resolve a controversial question, or the Revenue Service changes its position, or regulations are issued.

Compliance with Rules Essential. The Internal Revenue Service has, with but few exceptions, discretion as to whether to issue a ruling or closing agreement. Accordingly, failure on the part of a taxpayer or his representative to follow the rules required when submitting a request could result in the Service's refusing to issue a ruling or in delays resulting from re-submission of the request in accordance with the rules.

REQUESTS FOR ADVANCE RULINGS

The Service procedural rules and Section 7 of Revenue Ruling 54-172 prescribe what a request for a ruling must contain and general instructions in connection therewith. In addition, the Service recently issued Rev. Proc. 59-22 (CB 1959-1, 834) stating that

henceforth strict compliance on the part of taxpayers with the rules regarding requests for rulings as set forth in Revenue Ruling 54-172 would be necessary. The necessary elements of a request for a ruling are as follows:

General Elements. Requests for rulings should be submitted in duplicate, particularly if more than one issue is presented in the request or if a closing agreement is also requested. Duplicate filing thus permits simultaneous consideration of the request by two Service officials, important in cases involving more than one branch. Further, requests for rulings should be addressed to the Commissioner of Internal Revenue, Washington 25, D. C. In addition, requests relating to prospective transactions should not contain alternative plans.

Factual Elements. In the preparation of a request for ruling, the importance of setting forth all the pertinent facts cannot be too strongly emphasized. The request should contain a full and complete statement of all material facts of the transaction, with exact names and addresses of all interested parties. Copies of all revelant contracts and other documents should be attached; and, if the request involves a liquidation, distribution, reorganization or similar transaction, the corporate balance sheet nearest the date of a past transaction or the most recent balance sheet for a prospective transaction should also be supplied. When documents are filed, they should be accompanied by an analysis of their bearing on the issue or issues in question, specifying the pertinent provisions. Original documents should not be furnished, since they will be retained in the Service files.

A ruling will be followed *only* if there has been no omission or misrepresentation of a material fact. In this connection, accuracy is essential, as the Service generally copies the taxpayer's statement of facts in its ruling, which is not effective, if the actual facts are materially different. Incomplete or poorly organized statements and undocumented statements run the risk of requiring more time for obtaining supplemental information, inviting an adverse decision because the factual basis for a favorable ruling is not clearly set forth, and they may result in a valueless ruling if a later audit discloses that the transaction did not take place as represented.

Setting forth all the material facts may be relatively simple in certain situations, but as the tax problems become more complex, the presentation of the facts becomes increasingly difficult. This will raise the issue of deciding where to draw the line between a full statement of all relevant facts on the one hand, and an unnecessary recital of immaterial information on the other hand. It is obvious that this determination will vary greatly, depending upon the particular circumstances of each case. Nevertheless, to the extent that there is an element of doubt, good practice dictates stating more rather than less of the factual background.

Business Reasons. The request should contain a full and precise statement of the business reasons for the transaction. In this respect, the Internal Revenue Service is more likely to render a favorable ruling upon a transaction having a business purpose rather than one motivated solely by a desire to reduce taxes.

In addition, it is often advisable to point out the effect of the transaction upon the taxpayer's future status or operations. Moreover, give all the bona fide reasons without adding purported business reasons which are superficial and which have no factual foundation.

Analysis. A taxpayer asking for a

particular determination should submit an analysis of the reasons why the Internal Revenue Service should rule favorably. In requesting the Service to rule a certain way, particularly in complex and difficult situations, it is essential to analyse the transaction in light of governing code provisions, regulations and decisions. In this connection, Revenue Ruling 54-172 states "that if a taxpayer is contending for a particular determination, he must submit an explanation of the ground for such contention together with a memorandum of relevant authorities." Rev. Proc. 59-22 goes on to say that "even though the taxpayer is urging no particular determination or determinations with respect to a prospective transaction, it is required that he state his views as to the tax results of the proposed transaction, accompanying them with a memorandum of relevant authorities."

Since the Service will naturally respect its own interpretation of the governing law, it is advisable to utilize published rulings whenever possible and not to rely on cases in which the Service has declared its non-acquiescence.

The length of the anlysis and the number of citations of authority are a matter of judgment. Argumentative discussion should be avoided. At all times it should be remembered that a request for ruling is not a brief, but instead is an attempt to induce administrative officials to take discretionary action.

Conference. If the taxpayer or his representative desires an oral discussion of the case, he should indicate his desire in writing when filing the request, or shortly thereafter, in order that a conference may be arranged at that stage of the consideration of the case when it will be most helpful. Ordinarily, more than one conference will not be granted unless the taxpayer has important new matter to present, or unless the problem involved requires the consideration of the case by different divisions or offices of the Internal Revenue Service.*

Special Treatment. If the taxpayer or his representative desires a specially expeditious treatment of his request, such request should be incorporated within the body of the ruling or by a separate transmittal letter with a clear reason for such need.

Closing Agreement. If a taxpayer seeks a closing agreement, it should be stated in the request for ruling. It is not wise to wait until the request has been filed and processed to notify the Service that the taxpayer desires a closing agreement, since this will probably put the request on the bottom of the pile.

Signature. A request for ruling must be signed by the taxpayer or his duly authorized representative. If a representative signs, a statement of evidence to practice before the Treasury Department (pursuant to circular 230) should be stated. In addition, a power of attorney of the taxpayer in duplicate should accompany the request.

Order. There is no hard-and-fast rule as to the actual manner in which the request for ruling should be presented. Styles vary greatly from one individual to another. In any case, the objective is always to present the request as clearly as possible. As an aid to this goal, it is advisable to set forth somewhere in the request a clear and concise statement of the questions which the taxpayer wants answered. This should reduce to the absolute minimum any possibility of later confusion as to what the ruling covers.

The diplomatic approach to drafting a request for a ruling should also be considered. Since a ruling is

* See TIR-288, 1961 P-H ¶54,657, 1961 CCH ¶6260, regarding new conference procedures.

a matter of administrative discretion, taxpayers should not ask for more than is reasonably fair. Moreover, one should not expect the Service to be overly enthusiastic over a proposed transaction which is patently a tax avoidance scheme.

An application that does not comply with the requirements of the Service will be acknowledged by a form letter indicating the requirements that have not been met, and stating that the case has been closed until the application is completed in conformity with the requirements.

CLOSING AGREEMENTS

Closing agreements, as distinguished from rulings, have a statutory base. (Section 7121). The execution of a closing agreement, however, like the ruling letter, lies wholly within the discretion of the Commissioner. Actually, the closing agreement represents only a more formal action as to the tax treatment of an item involved than does a ruling.

Closing agreements are, by their nature under the statute and in form, of distinctly two kinds. The first relates to tax liability or items for past years, executed on Form 866; the second relates to prospective transactions, executed on Form 906. They are processed in a manner similar to that of requests for rulings.

There are certain limitations, however, on the circumstances under which a closing agreement on Form 906, as distinguished from a ruling, will be issued by reason of the very nature of the closing agreement. Due both to the binding future effect of a Form 906 closing agreement and to the demands placed upon the time of the high level officials required to participate in a closing agreement, it has been the policy of the Service to decline to enter into such an agreement in the absence of a showing by the taxpayer of a sound business necessity therefor. Accordingly, a taxpayer desiring a closing agreement in addition to a ruling should not only specifically request the closing agreement but also state the reasons which he believes make it necessary that the closing agreement be issued, and whether or not it is to the advantage of the Government.

PROCESSING OF REQUESTS FOR RULINGS

When a request for a Revenue ruling is received in the national office, it is referred to the Tax Rulings Division, which is one of the four divisions under the Assistant Commissioner (Technical). The tax rulings function is centered in the one division for the purpose of achieving the greatest degree of consistency and coordination, regardless of the particular tax which may be involved. The Director of the Division directs the activities of various "branches" which have the immediate responsibility for processing requests for rulings. The branches and their basic functions are as follows:

Individual Income Tax Branch. It handles rulings relating to the income tax of individuals, estates, trusts and partnerships.

Corporation Tax Branch. It develops rulings with respect to the application of income taxes and related statutes applicable to corporation matters generally. It also has sole responsibility for questions relating to consolidated returns, renegotiation, amortization and changes in accounting methods and periods. In addition, it handles rulings under Section 1361, relating to the election of an unincorporated business enterprise to be taxed as a corporation, and has jurisdiction over Sections 381 and 382, governing carryovers in corporate acquisitions.

Reorganization and Dividend Branch. It handles all questions arising under Subchapter C of the 1954 Code, except Sections 381 and 382. It also develops a substantial volume of requests dealing with the taxable status of dividends partially out of capital.

Estate and Gift Tax Branch. It handles rulings with respect to estate and gift taxes. However, it does not rule on prospective estate tax questions. Rulings are issued in estate tax questions if death has already occurred but the return has not been filed. Prospective rulings in gift tax cases are issued provided the question is presented in good faith.

Excise Tax Branch. It covers rulings on excise taxes on admissions, dues, transportation, manufacturers' and retailers' sales and other federal excise taxes (other than alcohol and tobacco taxes). In certain situations, it resolves factual as well as legal issues.

Pension and Exempt Organization Branches. It develops rulings on the qualification of organizations for exempt status under Section 501, reviews determination letters issued by District Directors' offices as to exempt status and as to the exempt status of pension trust and profit-sharing plans under Section 401 of the Code. It also develops rulings in appropriate cases on related matters, such as the deduction of contributions to such organizations.

Employment Tax Branch. It develops rulings with respect to federal employment taxes, income tax withholding on wages and certain aspects of the self-employed tax.

Branch Procedures. When a request for a ruling is referred to the appropriate branch of the Tax Rulings Division, the chief of the branch will refer it to a technician within his branch for consideration and development of a proposed ruling. Branch chiefs have authority to issue rulings on behalf of the Internal Revenue Service. They do not issue rulings, however, on matters in which the authority has been expressly reserved to other officials or on policy or legal issues that should be passed upon by higher authority.

Where a request for a ruling involves matters beyond the jurisdiction of one branch, it is the general practice to have the proposed ruling prepared in part by each of the branches and to be signed at the level of the Director of the Division.

While, numerically, only a small percentage of rulings are referred to the Chief Counsel for consideration, generally there are four situations in which a proposed ruling will be referred to the Chief Counsel's office for legal advice. These include proposals involving:

- A new legal question
- A conflict in legal precedent
- Conclusions reached which might likely result in litigation, and
- Administrative policy.

Moreover, all proposed closing agreements are referred to the Chief Counsel's office after they have been prepared in the Tax Rulings Division.

A taxpayer may request a conference in the Chief Counsel's office if his case is referred there, and such requests will generally be granted. Often this will be a joint conference with representatives of the Tax Rulings Division present.

Procedure on Withdrawal of a Request for a Ruling. Requests for rulings may be withdrawn at any time prior to the signing of the letter of reply by the Internal Revenue Service. However, the withdrawal of the request will not prevent the National Office from furnishing its views to the District Director in whose office the return

will be filed. Neither will such withdrawal prevent a District Director from considering the information submitted in a subsequent audit of the taxpayer's return. Moreover, even though a request for a ruling is withdrawn, all correspondence and exhibits are retained in the files of the Internal Revenue Service and will not be returned to the taxpayer.

Aftermath of Issuance of a Ruling. Once a ruling is issued, it will be sent to the taxpayer in duplicate, of which one copy should be attached to the return for the year in which the transaction occurs. The examining officer, upon an audit, has the obligation to compare the facts with the representations upon which the ruling was based, to ascertain whether there has been a misstatement or omission of material fact or whether the transaction upon which the ruling was based was actually carried out in a manner materially different from that represented. If the agent questions the validity of the ruling, the taxpayer has the right of appeal and, if necessary, he will have the opportunity to file a brief and obtain a hearing in the National Office.

The duties of the Agent with respect to verification of the facts lend added emphasis to the importance of a full and complete presentation of the facts. In this connection, it becomes essential to review the ruling throughly to make certain that the facts there stated do not vary from those stated in the request and in any supplemental materials. If an error is discovered, contact with the National Office should be made immediately to get the ruling corrected.

If, upon receipt of the ruling, it becomes necessary to vary the transaction in some manner, the taxpayer should notify the Internal Revenue Service by submitting a supplemental letter explaining the change in facts and requesting that a determination be made that the ruling is still in effect. Unless there is a material change, the Service will generally reply favorably to the request.

DETERMINATION LETTERS

Although the discussion thus far has been related almost exclusively with the issuance of rulings by the National Office, the principles underlying the issuance of "determination letters" are similar in many respects of those relating to rulings.

District Directors of Internal Revenue, as the operating officials of the Service, under the supervision of the Regional Commissioners, "apply the statute, regulations and rulings of the National Office in the determination of tax liability and the collection of taxes." In applying these statutes, regulations and rulings, the District Directors are authorized to issue determination letters. They are intended to be solely the "application of the facts involved in a particular enquiry or request of the principles and policies previously established by the National Office." It is clear from the concepts and definitions stated in the Statement of Procedural Rules that if a District Director receives an inquiry which cannot be directly answered pursuant to clearly established precedent, the District Directors' offices will not issue a determination letter.*

Generally the same principles and policies regarding the completeness of an inquiry or request and the discretionary authority to answer it apply to determination letters as apply in the case of rulings requested from the National Office. Thus, a District Director may refuse to issue a determination letter where it would be necessary to resolve a factual issue.

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* Such inquiry is generally referred to the National Office by the District Director or by requesting the taxpayer to refer the matter to it.

Limitations on Issuance of Determination Letters. Determination letters may not be issued with respect to prospective transactions. They may be issued only with respect to completed transactions, generally in order to advise the taxpayer how such transaction should be reported on his tax return. Moreover, they may be issued only where the question presented is specifically covered by statute, regulation, ruling or court decision published in the Internal Revenue Bulletin. The only exceptions to the mandate that District Directors may not issue determination letters covering the income, profits, estate or gift tax consequence of prospective or proposed transactions are (a) in the area of employees' trusts; (b) certain areas of the exemption of organizations from income tax under Subchapter F of the Code; and (c) in respect of withholding, employment and excise taxes.

In addition, determination letters may not be issued with respect to a question which is involved in a return already filed by the taxpayer. Likewise, a determination letter will not be issued if a similar request has been made to the National Office, or where the determination letters are being sought by an industry, trade association or similar group, or where the request involves an industry-wide problem. Neither will a determination letter be issued unless the taxpayer requesting it is territorially under the supervision of the District Director to whom the request is made. These limitations are for the purpose of preventing taxpayers or groups of taxpayers from "shopping around" among the various District Directors' offices in an attempt to obtain a favorable ruling.

Processing Procedures. In the District Directors' offices, the determination letters are issued by the Audit Division. In a typical situation, the Chief of the Audit Division usually refers requests for determination letters to selected group chiefs who in turn transfer them to agents selected for their writing ability and knowledge. The drafts are checked by the group chiefs and then by a review group in the office of the Chief of Audit Division, who generally signs the letters in the name of the District Director. Pension plan and exempt organization problems which involve specialized questions are dealt with by agents whose entire time is devoted to such work.

Aftermath of Issuance. A copy of the determination letter should be attached to the appropriate return. A taxpayer who is unsatisfied with a determination letter, however, can request the District Director to refer the matter to the National Office either (a) as an initial request for a ruling,* or (b) as a request for technical advise from the National Office. If the matter is referred to the National Office, the taxpayer will ordinarily have the opportunity to file a brief and secure a conference in the National Office if desired.

BINDING EFFECT OF RULINGS AND DETERMINATION LETTERS

Technically, no written statement by an official of the Internal Revenue Service is final and conclusive, except a formal closing agreement under Section 7121. Nevertheless, for a number of years the Service has followed an informal but established practice of respecting its rulings. The Service finally expressed its views officially in Rev. Rul. 54-172 and the Service Procedural Rules by stating, as a general policy, that modification or revocation

* This may be done on the ground that the question involved is more complex than was initially realized and, therefore, is not an appropriate subject for a determination letter.

of a ruling will not be applied retroactively to the particular taxpayer provided:

1. The request did not misstate or omit material facts;
2. The facts subsequently developed were not materially different from those on which the ruling was based;
3. There was no change in the applicable law;
4. The taxpayer acted in good faith in reliance upon such ruling and;
5. Retroactive revocation would be to the taxpayer's detriment.

The above principles and guides represent the position that the Service has taken for many years. Accordingly, a taxpayer submitting an accurate and complete statement of all the material facts and acts in reliance thereon has, as a practical matter, good insurance as to the outcome of the transaction requested in a ruling or determination letter.

Considering the thousands of rulings and determination letters issued by the Service, it is impractical to notify individually every taxpayer of a change in position, interpretation or the law which may affect a prior ruling. In this connection, a taxpayer with a favorable ruling must be alert to the possibility of revocation without direct notice.

Aside from changes in the statute to which knowledge is imputed to all taxpayers, there are three methods of revoking rulings to a particular taxpayer:

Letter notifying the taxpayer that the ruling issued to him is no longer binding.

Publication in the Internal Revenue Bulletin of a ruling or regulation which states a different position than that indicated in the ruling issued to the taxpayer. If a taxpayer is affected detrimentally by such retroactive revocation, he may apply to the Commissioner for a non-retroactive application of such new ruling or regulation.

Advice from the District Director upon audit of the taxpayer's return that the ruling is not applicable. In this situation, the taxpayer should refer the matter to the National Office.

PRACTICAL CONSIDERATIONS

The primary consideration facing the tax practitioner is the decision as to whether or not it is in the taxpayer's interest to seek a ruling or determination letter. Basically, the problem is to weigh the desirability of obtaining a high degree of tax certainty against the time and expense involved in obtaining a ruling, and against the consequences of obtaining an adverse ruling or no ruling at all. Nevertheless, the decision will invariably turn upon all the relevant facts in a given situation.

One of the most important things to consider is whether or not a ruling or determination letter is needed. If the research by the tax practitioner clearly shows what the tax results will be under the statutes, regulations, rulings and reported decisions, the case is not an appropriate one for a request for a ruling or determination letter. On the other hand, a request for a ruling or determination letter in a situation where there are clearly defined regulations, rulings, or acquiesences in court decisions, offers the advantage of guarding against a change of Service policy.

Where substantial tax or complicated facts are involved, a ruling may be desirable on the grounds of uncertainty as to application of the law to the facts. In this connection, another taxpayer's ruling or a published ruling that appears to fit the facts in a particular case should not automatically be relied upon, since an examining

agent might consider the other ruling distinguishable from the client's facts.

In addition, it should be recognized that obtaining a ruling is not an automatic procedure. It is essentially a request to an opposing litigant to secure a judicial response. In this regard, this raises the dangers of disclosing unnecessary facts and calling the attention of a particular transaction to the service.

In presenting a case to the Service, all relevant facts, even though adverse, should be disclosed. Unless this is done, the misstatement or omission of material facts can serve as a basis for retroactive revocation of the ruling itself. Nevertheless, where certain facts are susceptible to various interpretations, although adverse and without having a bearing upon the tax issue involved, it would seem that there is no obligation to gratuitously present them as part of the request.

It is essential for the tax practitioner to evaluate the likelihood of securing a favorable ruling. Thus, an analysis of statutory and policy restrictions should be made.

Futhermore, in considering the possibility of obtaining a favorable ruling, the practitioner should take into account the effect of the request on other parts of the law. In this respect, the Service might be unwilling to rule with respect to the application because it would be contrary to its policy already established with respect to another part of the law.

Effect of Unfavorable Ruling. If a ruling is unfavorable, a copy thereof, together with other pertinent documents, normally will be forwarded to the District Director's office which invariably results in an audit. Moreover, this unfavorable ruling is binding on the examining officer. If a proposed transaction is incapable of being recast in some other form, a ruling should not be requested if there is any real possibility of the Service ruling unfavorably. Nevertheless, an unfavorable ruling has the advantage of forewarning the taxpayer of the tax treatment to be expected and thereby gives him an opportunity of formulating an alternative plan.

If a client proposes to consummate a particular transaction, irrespective of the tax consequences, it generally is not advisable to ask for a ruling. In such a case, it is probably best to report the transaction in the manner in which a favorable response would have been treated if a ruling were requested.

Preliminary Informal Conferences. The importance of an informal conference with officials of the Tax Rulings Division prior to submitting a formal application cannot be overemphasized.

Through such conference, alternative courses of action considered by the taxpayer can be explored and valuable suggestions obtained in framing both the details of the transaction and the request itself. Moreover, the practitioner frequently can ascertain the Service's attitude after the existence of intra-office policy and unpublished memoranda or rulings is made known.

Informal conferences can also be useful to eliminate alternative methods, since the Commissioner will not rule where the formal request presents such alternatives.

CONCLUSION

The rulings procedure affords taxpayers and their representatives an important and valuable method to work out the answers to various tax problems without the delays and formalities attendant upon litigation. A proper approach and use of the rulings procedure should go a long way to provide answers to tax problems and an early determination of tax liability when warranted.

State and Local Taxation

NEW YORK STATE TAXATION

Conducted by PHILMORE H. FRIEDMAN, CPA

DECEDENT'S FINAL RETURN

There is a substantial difference in the reporting requirements with respect to a decedent's final New York State Income Tax Return, under the present law, from that which was in effect prior to the time that New York State adopted the conformity legislation.

Article 16 (the old law) required that amounts which accrued up to the date of the decedent's death be included in the decedent's final New York State Income Tax Return, except that such amounts may have been excluded if a bond were filed and certain other conditions met. Thus, "income in respect of a decedent," those amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income under his method of accounting, (i. e., cash method), were includable in the decedent's final return. Contrastingly, under new Article 22, which adopts the federal rules, the decedent's final return (for cash basis taxpayers) includes only income actually or constructively received in the year up to the date of his death. In other words, a cash basis decedent is not placed on an accrual basis for the purpose of filing the final income tax return. However, items of income in respect of a decedent which are not includible in gross income for the decedent's last taxable year will be includible in the gross income of those persons subsequently receiving such income provided, of course, that when received such persons are residents of New York.

We should be mindful that where a decedent died prior to January 1, 1960, (the effective date of Article 22) the accrued income items will have been included in New York taxable income in the decedent's final New York return and therefore, to avoid double taxation of the same items of income, are not required to be included in New York adjusted gross income of those persons subsequently receiving such income. Consider the following illustration:

In 1959 a decedent left his son \$10,000 in accounts receivable. The executor properly included the \$10,000 in the decedent's final 1959 New York State Income Tax Return but not in the federal return. In 1961 the son received the \$10,000 which he will include in his 1961 Federal Adjusted Gross Income. How is the \$10,000 to be treated for New York State Income Tax reporting purposes? While New York adjusted gross income is the same as the Federal adjusted gross

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income, an adjustment is provided for with respect to those items of income previously included in New York taxable income computed under the prior income tax law. Therefore, in filing the 1961 New York State Income Tax Return, the $10,000 will be subtracted from the Federal Adjusted Gross Income to arrive at the New York adjusted gross income.

Another interesting change with respect to the filing requirements of decedent taxpayers is that a joint New York State income tax return may be filed for the decedent and the surviving spouse, provided that a joint Federal income tax return was filed. Under prior law, a separate New York State income return was required to be filed for the decedent. The decedent's final New York State income tax return will be due on the same date as if the decedent had lived until the end of his last income-tax taxable year.

TAXATION OF PARTNERSHIP INCOME AND TRUST INCOME OF A RESIDENT WHO BECOMES A NON-RESIDENT OF THE STATE

A taxpayer who changes his residence from New York State to another state, during taxable year, is required to file two New York State Income Tax Returns covering his period of residence and non-residence. His resident return will include income from all sources but his non-resident return will include income only from sources within New York State. To safeguard revenue which might otherwise not be collected, the cash-basis taxpayer is placed on an accrual method of accounting for the purpose of determining New York taxable income in his final resident return. This rule presents an interesting result with respect to the reporting requirements of a partner of a non-resident partnership or of a beneficiary of a trust or estate.

Consider the following illustrations:

N. Y. taxation of a partner of a non-resident partnership. A New York resident, a calendar-year taxpayer, is a member of a calendar-year non-resident partnership which does no business in New York. The individual becomes a resident of Connecticut on December 1st, 1961, and his distributable share of partnership income for calendar year 1961 is $20,000. How much of the partnership income, if any, is the partner required to report on either of the two New York State Income Tax Returns he will file for 1961?

The individual would not be required to report any partnership income on either of the two 1961 returns. This result stems from the fact that a partner's distributable share of partnership income is included in the computation of taxable income for that portion of his taxable year, whether resident or non-resident, in which the taxable year of the partnership ends and is determined by the individual's status as a resident or non-resident at that time. The distributable share of partnership income is not prorated for the period of the partner's resident or non-resident status. Thus, even though an individual who moves into or out of New York State is placed on an accrual method, the "entity rule" governs with respect to the reporting requirements of income from a partnership. This rule would govern even if the partner were receiving his compensation from the partnership in the form of guaranteed salary.

Alternatively, a non-resident who is a member of a non-resident partnership doing no business in New York who becomes a resident of New York during the taxable year will discover that his entire share of the partnership's income is includable in New York taxable income in the year of

change of residence even though he may have been a resident of the State for a short time during such year. Therefore, where a member of a calendar year non-resident partnership, which does no business in New York, becomes a resident of New York on December 10th, 1961, the partner would be required to report on his resident return (which covers only a fifteen day period) his distributable share of the partnership income for the entire taxable year. The fact that the greater part of his income was earned while he was a non-resident does not change the result. Under such circumstances, it would be prudent for the individual to delay the start of his New York residence until after the completion of the full taxable year of the partnership. If the partner in the above example had moved to New York on January 2nd, rather than on December 15th, the entire year's partnership income of the prior year would permanently escape New York State income tax.

N. Y. taxation of a beneficiary of an estate or trust. The "conduit" principle rather than the "entity" rule governs with respect to the taxation of a beneficiary of an estate or trust who moves from the state during the taxable year. Thus, New York State would require the beneficiary to report on his resident return any estate or trust income actually or constructively received by him during his period of residence in the state. Moreover, since he is required to accrue income and gain on the return filed by him for the period immediately preceding his change of residence, he would be expected to include on his final resident return any estate or trust income credited, distributable (or required to be distributed) to him as of the date of his change of residence unless, of course, he files a bond or other security under the provisions of Section 654 (c) (4) of the Tax Law. Within the framework of the above rules, consider the following situation:

A trustee of a calendar year trust was required under the terms of the trust indenture to distribute the entire trust income (which consisted of dividends and interest) to the beneficiary each year. The taxpayer became a non-resident of New York on June 30th, 1961. The beneficiary is required to report on his resident return any dividends or interest actually or constructively received by him during the first six months of 1961. He also must include on his resident return any dividends or interest or other trust income credited to his account or otherwise required to be distributed to him as of June 30th, 1961.

It should be recognized that the above comments are necessarily subject to provisions of the regulations which are presently being drafted to implement and interpret Article 22 of the Tax Law.

STATE TAXATION, OTHER THAN NEW YORK

Conducted by S. ZACHARY SCHEER, CPA

STATE USE TAX IMPOSED ON STORED INTERSTATE TRUCK REPAIR PARTS

Hunnewell Trucking, Inc., an interstate carrier, stored in a Maine terminal tires and motor parts that it had purchased tax-free outside of the state, for installation, as needed, on its trucks operating in interstate commerce.

The Maine Supreme Court ruled that the Maine use tax may be imposed, without burdening interstate

commerce, since the trucker had caused these goods to come to rest within the state for its own convenience and profit.

U. S. SUPREME COURT TO REVIEW CALIFORNIA PROPERTY TAX CASE

The highest court has been asked whether foreign-owned, based and registered airplanes flying solely in foreign commerce may be subjected to a local ad valorem property tax that is apportioned on a time-in-the-jurisdiction basis. (*Scandinavian Airlines System, Inc. v. County of Los Angeles*) This is an appeal from a decision of The California Supreme Court which thought tax was due.

PENNSYLVANIA TAX EXEMPTIONS GRANTED TO "PROCESSORS"

Pennsylvania has enacted legislation broadening the exemption provisions of the Pennsylvania Sales and Use Tax and the Capital Stock and Franchise Taxes to include "processors."

Sales and use tax exemptions have been expanded to include tangible personal property and services used directly in the processing of personal property, as defined. Capital stock and franchise taxes have been changed by adding to the existing manufacturers exemption from such taxes the business of processing personal property, as defined.

The term "processing," for the purpose of these exemptions, is limited to include specified activities listed in the new statutes, when engaged in as a business enterprise. Some examples are: cooking or freezing food for wholesale distribution; treatment of metals and plastics (such as galvanizing, electroplating, and heat treating) for sale or in the manufacturing process; production, processing and bottling of non-alcoholic beverages for wholesale distribution.

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MUNICIPAL AND LOCAL TAXATION

Conducted by ROBERT I. EDELSON, CPA

NEW BASE PERIOD DETERMINATION FOR N. Y. CITY GROSS RECEIPTS TAX

In the September column, attention was directed to the new Regulation Article 105a of the New York City Gross Receipts Tax Regulations. This regulation discusses the rules applicable to base periods for privilege periods beginning July 1, 1961. In view of the fundamental importance of this regulation, the two rules and accompanying examples are given in their entirety.

For privilege periods beginning July 1, 1961, the rules for determining the basic period are as follows:

Rule 1. If the taxpayer is engaged in a taxable activity within the City of New York during the period beginning July 1, 1961, and ending December 31, 1961, or any part thereof, the basic period is the entire calendar year 1961, provided, however, that if the taxpayer has reported in a return for a prior period his gross receipts or gross income for a portion of such calendar year, the tax is measured by his gross receipts or gross income during the balance of the year. To illustrate:

(1) A person is engaged in general business during the entire calendar year 1961. For the privilege period

from July 1, 1961, to December 31, 1961, his basic period is the entire calendar year 1961. He is required to file a return and pay the tax measured by his gross receipts for the entire calendar year 1961 (the basic period.)

(2) A person commences general business on April 1, 1961, and continues it for the remainder of 1961. His basic period is April 1, 1961, to December 31, 1961. First, he is required to file a return and pay the tax measured by his gross receipts for the period from April 1 to June 30, 1961, for the prior privilege period July 1, 1960, to June 30, 1961. Then he is required to report and pay the tax for the privilege period July 1, 1961, to December 31, 1961, measured by his gross receipts for the balance of the basic period, i.e., from July 1, to December 31, 1961.

(3) A person commences general business on September 1, 1961, and continues it for the remainder of 1961. His basic period is September 1 to December 31, 1961. He is required to file a return and pay the tax for the privilege period from July 1, 1961, to December 31, 1961, measured by his gross receipts for the basic period, i.e., September 1, 1961, to December 31, 1961.

Rule 2. If the taxpayer is engaged in a taxable activity within the City of New York during the calendar year 1962, or any part thereof, and each subsequent calendar year, or any part thereof, the basic period is such calendar year. To illustrate:

(1) A person is engaged in general business during the calendar year 1962. His basic period is the entire calendar year 1962. His privilege period is January 1, 1962, to December 31, 1962. He is required to file a return and pay the tax for such privilege period measured by his gross receipts for the calendar year 1962.

(2) A person commences general business on March 15, 1962, and continues it for the remainder of 1962. His basic period is March 15 to December 31; his privilege period is March 15, to December 31, and he is required to file a return and pay the tax for such privilege period measured by his gross receipts for the period March 15, 1962, to December 31, 1962.

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APPEAL FROM N. Y. CITY GROSS RECEIPTS TAX ON MOVIE PRODUCERS

An appeal is being taken to the United States Supreme Court, from the decision of the Court of Appeals in *Twentieth Century-Fox Film Corporation v. Gerosa*. This case involves the imposition of the New York City Gross Receipts Tax to the gross receipts of a producer of motion pictures. The pictures were leased or sold to distributors for use outside of the United States. All payments to the corporation were made in New York. The distributors were subsidiaries of the producer.

Among the problems at issue was the question whether the tax was levied on exports to foreign countries, in violation of Article 1 of The Constitution of The United States, or whether the tax was levied "upon the sale or lease of rights with respect to prints of motion pictures before the customer started them in the stream of foreign commerce. . . ." The Court of Appeals held there was no such violation.

STATE COMPTROLLER MAY EXAMINE SALES TAX RETURNS

By authority of Chapter 278, Laws of 1947, any county in New York State (except those wholly within New

York City) and any city with a population under one million may impose retail sales, use, admissions, privilege, and other local taxes. These local resolutions are required to contain secrecy provisions. In general these provisions contain the following wording:

"Except in accordance with proper judicial order, or as otherwise provided by law, it shall be unlawful . . . to divulge or make known in any manner the receipts, expenses, or other information relating to the business of a taxpayer. . . ."

In the case of *Arthur Levitt*, Comptroller of the State of New York *v.* the Director of the Department of Sales Tax of Erie County, and the Assistant Deputy Treasurer of Monroe County, the Supreme Court, Appellate Division, decided that the Comptroller was permitted to examine individual sales tax returns. The secrecy provision did not apply to the Comptroller, since he has a duty to examine the accounts of all officers of each municipality and district. The Comptroller is included in the exception "as otherwise provided by law."

Payroll Tax Notes

Conducted by Samuel S. Ress, CPA

RECENT UNEMPLOYMENT INSURANCE DECISIONS

Corporate officer not totally unemployed. Two recent decisions of the New York Unemployment Insurance Appeal Board ruled on the rights of officers and stockholders to receive benefits.

In Appeal Board Case No. 83,773, the claimant and another individual were officers and sole stockholders of a corporation which normally employed more than 25 employees. During a slack period, claimant, whose major duties were that of a foreman, became idle and he applied for benefits. He informed the claims interviewer that he was idle because his business was in process of being liquidated and that he was negotiating to sell his interest in the corporation. Claimant eventually resigned as an officer of the corporation and transferred his stock interest to a third party for $3500.

The Appeal Board stated that a corporate officer and stockholder who retains his interest in and association with a corporation, and continues to serve as one of its principal officers, is not totally unemployed although he may not have received salary or drawings during a period in which he was idle. (AB#80,800) Claimant was held not unemployed until the date on which he disposed of his stock interest in the corporation and ceased to be on officer of the firm.

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Husband and wife employment. Appeal Board case number 82,298 involved a claimant who was secretary-treasurer of a contracting corporation of which her husband was president and sole stockholder. Claimant was employed by the corporation as a general office worker. The business of the corporation was seasonal, being inactive during the winter months. Claimant received salary only when the business was active. The husband fixed the rate of pay of all employees of the corporation including that of claimant. As an officer, the claimant attended meetings and signed checks and reports of the corporation.

In December, 1960, the corporation suspended operations and the claimant's salary was discontinued. The corporation was in financial difficulty and never resumed operations. Claimant's husband, president of the corporation, obtained employment with another firm in March 1961, and all efforts to continue the business thereafter were abandoned. The claimant sought to collect unemployment benefits from December, 1960, when her services ceased.

The Appeal Board held that although claimant did not receive remuneration from the corporation during the slack period, she continued to hold office in the corporation. It was deemed of compelling significance that the corporation was wholly owned and operated by plaintiff's husband and it was, therefore, possible to control the amount and duration of remuneration paid to the officers of

the family corporation. The Appeal Board cited AB#80,474-61 and AB#81,439-61, in denying benefits to claimant until March 6, 1961, when the business was definitely abandoned.

BENEFIT SUSPENSION DUE TO INDUSTRIAL CONTROVERSY

Three maintenance workers and a payroll clerk applied for unemployment insurance benefits during an industrial controversy at the employer's establishment. The State suspended their rights to benefits during a period of seven consecutive weeks, effective the day after the dates of loss of the respective employments of each claimant. It was held that they lost their employment because of an industrial controversy in the establishment in which they were employed.

In this case, a contract between a *production* workers' union and the employer expired December 31, 1960. The union was requested to permit the workers to continue in employment with the employer during negotiations and pending a new agreement. The union refused to go along with the employer's request and a stoppage on the part of the production workers took place on January 15, 1961, after the employer stopped ordering new raw materials and started laying off some production workers on January 12, 1961. The remainder were laid-off on January 13th, 1961, with the exception of the maintenance workers and the payroll clerk who continued working until January 20, 1961. The latter were laid off by the employer because of lack of heat in the premises. There was no labor dispute between the employer and the *maintenance* workers' union. The payroll clerk was a member of no union and was not involved in the industrial controversy. She would have continued working had she not been laid-off by the employer.

The Referee held that the payroll clerk and the maintenance workers should not have been suspended from accumulating benefit rights for the seven week period following their respective loss of employment, on the authority of *Matter of Wentworth,* 10 NY 2nd 13.

The Appeal Board reversed the decision of the Referee, holding that *Matter of Wentworth* was not in point. It ruled, (Appeal Board Nos. 82,557, et al.), that the loss of employment by the payroll clerk and maintenance workers was directly attributable to an industrial controversy in their place of employment. The maintenance workers were employed and worked in the same industrial establishment as the striking production workers. The Appeal Board cited *Matter of Lasher,* 279 App. Div. 505, in which the Court stated:

> ". . . it is of no consequence whatever that claimants were not on strike; that they were not aiding the strike, financially or otherwise; that they were employed in a separate branch of work, or that they lost their employment through no fault of their own. . . ."

All of the claimants were held to have lost their employment as a result of an industrial controversy in their establishment, and their benefit rights were suspended accordingly, for 7 weeks.

In the Wentworth case an industry-wide strike had been called by a Teamsters' Union. As a result, truck drivers of firms from which the employer obtained its concrete went on strike. Because of bad weather and a lack of materials, the employer in the Wentworth case laid off some carpenters in its employ. The Court held that the suspension period provided by section 592.1 of the unemployment insurance law should not be applied where claiments' loss of employment was not caused by the participation of the employers' employees in the strike.

York City) and any city with a population under one million may impose retail sales, use, admissions, privilege, and other local taxes. These local resolutions are required to contain secrecy provisions. In general these provisions contain the following wording:

"Except in accordance with proper judicial order, or as otherwise provided by law, it shall be unlawful . . . to divulge or make known in any manner the receipts, expenses, or other information relating to the business of a taxpayer. . . ."

In the case of *Arthur Levitt*, Comptroller of the State of New York v. the Director of the Department of Sales Tax of Erie County, and the Assistant Deputy Treasurer of Monroe County, the Supreme Court, Appellate Division, decided that the Comptroller was permitted to examine individual sales tax returns. The secrecy provision did not apply to the Comptroller, since he has a duty to examine the accounts of all officers of each municipality and district. The Comptroller is included in the exception "as otherwise provided by law."

NOTICE

Because of vacation interruptions the monthly departments, Accounting and the SEC and Administration of a CPA Practice, do not appear in this issue.

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

TAX ACCOUNTING FOR CARRYING CHARGES

The problem of when income is to be reported still flourishes to plague the Courts. It would appear that once 'tax accounting' departed from the regularly accepted principles of accounting with the blessings of the Supreme Court, there existed no general rule to apply, and the factual differences in cases govern the doctrine. The lower courts appear to feel the same, and hence, base their decisions on the question of whether income is clearly reflected under the method of reporting for tax purposes. If in the court's opinion it is, the court proceeds to distinguish the case from the Supreme Court decisions.

In a recent case of a Vermont automobile dealer, a District Court decision held that the accrual basis taxpayer need not accrue and report as income in the year of sale, the carrying charges provided for in a time payment contract. The Court distinguished this case from the *American Automobile Association v. U. S.,* (discussed in NYCPA September, 1961, p. 637) on the grounds that here the taxpayer might never collect the carrying charges, while in the Supreme Court case the A. A. A. had actually received the dues for which it would have to render future service to earn them. Rather, the Court said, this case was comparable to *Bressner Radio Inc., v. Com.* (CA-2, 1959, 267 F (2d) 520, discussed in NYCPA August 1959, p. 604) in that any other method of accounting which would cause the carrying charges to be reported in the year the contract was signed, and before they were earned, would be erroneous. (*Smith Motors Inc. v. U. S.* USDC, Vt. 8/9/61).

Since an appeal of this case would be taken in CA-2 which decided *Bressner,* it will be interesting to follow its progress.

LOSSES DISALLOWED ON CONTRIBUTION OF DEPRECIATED ASSETS TO PENSION TRUST

Losses incurred through transfer of depreciated securities to a qualified pension trust are not deductible by the transferor corporation because it, the grantor, is considered to be related to the transferee, the fiduciary of the trust. Thus the loss would be nondeductible under Section 267 as a loss from the sale or exchange of property between related persons. Similarly, the loss on the sale of land to the trust by a subsidiary is not allowable, where the subsidiary contributes to the plan and its employees are covered by the plan (Rev. Rul. 61-163, IRB 1961-37, 11).

Obviously the exchange in the first instance above is the transfer of the securities in consideration of a release from the obligation to make the annual contribution under the pension trust formula. What would be the result in the case of a contribution to a profit sharing or other plan where no obligation existed? This question is particularly interesting in the light of the Circuit Court's decision in *USA v. General Shoe Corporation* (CA-6, 1960 282 F(2d) 9 disscussed in NY CPA November 1960, p. 792). There the court held that appreciated real estate contributed to a retirement trust where there was no legal obligation for such payment on the part of the corporation, was taxable to the extent of the appreciation of the property because the taxpayer realized intangible benefits i.e. the deduction of the contribution at appreciated value. In the case of a contribution of depreciated property, the only realized benefit would be the contribution deduction itself. This does not appear to be the 'benefit' alluded to by the Court in *General Shoe* (there the 'benefit' was increase in deduction due to appreciation in value which was otherwise not subject to tax). Without a 'realized benefits' would the loss be deductible under Section 1001 where there is no obligation on the part of the transferor and therefore no 'sale or exchange'? At the present time there is no clear-cut answer.

A CONTRACTUAL PROMISE TO PAY CAN BE THE EQUIVALENT OF CASH

A cash basis taxpayer is required to include in income only those items actually or constructively received during the taxable year. Payments in property generally are not held to be income unless the property has a 'fair market value' or 'cash equivalent'. And as a general proposition, executory contracts to make future payments in money do not have a fair market value. This doctrine was acknowledged by the Tax Court and by the Fifth Circuit Court of Appeals in a recent case (*Cowden et al v. Com.* CA-5, 4/12/61), but the Courts went on to point out that where such a contract could have value, the doctrine would not apply.

In 1951, Cowden entered into an oil and gas lease with Stanolind Oil, an affiliate of Standard Oil of New Jersey. The advance royalty agreed upon between the parties was approximately $510,000. Stanolind, in sound financial condition, was willing and able to pay this sum in full in 1951. However, in order to avoid the tremendous tax upon Cowden which would result from payment in one year, the parties contracted that Stanolind would pay $10,000 in 1951, and $250,000 in each of 1952 and 1953. This contract was the only evidence of Stanolind's obligation to Cowden. Shortly before the end of 1951, Cowden, for cash, assigned his right to receive the 1952 installment to a bank which often discounted such contracts without recourse, and in which he was a member of the Board of Directors. Similarly, in December of 1952 he assigned the 1953 payment to the bank.

The Commissioner claimed that the full $510,000 was taxable in 1951. The Tax Court held for the Commissioner. While it recognized the general rule that contracts to make future payments have no fair market value and thus no cash equivalent, it distinguished the cases which established

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this rule on the ground that in none of those cases were the payors willing to make full payment immediately. The Court reasoned that in view of the facts in the instant case, this particular contract had fair market value because: (1) contractual obligations of mineral lessees were generally discounted by banks in this part of the country, where the debtor had satisfactory financial responsibility; (2) Cowden was a director of the bank in question and knew that the bank would purchase Stanolind's obligation immediately; and (3) the bank, in fact, took such payment without recourse.

On appeal, the Fifth Circuit stated that the Tax Court, in determining that the contract had a cash equivalent, had placed too much stress on the fact that Stanolind was ready, willing, and able to make full payment in 1951. The Court said that parties are always free to make contracts as they please and reduce their taxes by any legal means available. Thus, the Commissioner cannot remake a contract between two parties to put the taxpayer in constructive receipt of $510,000 in 1951, simply because the obligor was willing to pay such sum at that time. On the other hand, although in prior cases it had not been held that there was a 'cash equivalent' in a mere contractual promise, it does not follow that there may not be situations in which a contractual promise *does* have a cash equivalent. Said the Court, "We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable . . . and is of a kind that is frequently transferred to lenders or investors, such promise is the equivalent of cash and taxable as cash would have been had it been received rather than the obligation." Accordingly, the Fifth Circuit sent the case back for the Tax Court to decide whether the obligations in question were the equivalent of cash, without giving excessive weight to the fact that Stanolind was ready and willing to pay the full price in the year of the contract. The Tax Court has now reconsidered the case and found that since the contractual obligations in question were readily assignable to the bank under the prevailing practice in this area, and were in fact so assigned, they had a 'fair market value', and therefore, a 'cash equivalent' equal to face value less the amount of the bank's discount charges against Cowden. (*Cowden,* TCM 1961-229 on rem'd. from CA-5, rev'g. & remd'g 32 TC 853).

MISCELLANIES

• Rev. Rul. 61-157 (I. R. B. 1961-35) embodies and brings up to date all of the Internal Revenue Service's latest guides for the qualification of stock bonus, pension, profit sharing, and annuity plans under Sec. 401(a).

• A CPA and lawyer who specialized in Federal taxation contended that, restricted by professional ethics, he had to publicize his calling "in a dignified and discreet manner." So he bought and operated a yacht and on it flew a red, white and blue house flag bearing the numerals "1040". The flag provoked inquiries; the inquiries presented opportunities to discuss business; and the discussions sometimes led to income. Therefore, the boat owner claimed ordinary and necessary promotional business expenses in connection with the operation of the yacht.

While conceding that a professional person should broaden his contacts in the interests of his practice, the Tax Court found that the operation of the boat was primarily for personal ends. The claimed deductions were not ordinary or necessary business expenses. (*Robert Lee Henry* 36 TC——No. 87).

• An owner of stock in a coopera-

tive housing corporation also has a lease upon an apartment for as long as he owns the stock. Where he subleases the apartment, he is not entitled to depreciate a portion of his investment "as an amount paid for a leasehold." The leasehold is inseparable from the stock since upon disposition of the stock, his rights would terminate. Thus the investment must be treated as any other stock purchase, and there is no separate tax basis for the leasehold. (Rev. Rul. 61-162, IRB 1961-37, 9).

COMMENTARY

DEDUCTIBILITY OF INVESTOR'S EXPENSES

A question often raised concerns the deductibility of various expenses paid or incurred by an individual in connection with the ownership of securities. Suppose an individual has a portfolio of 100 stocks. In order to keep proper records for the purpose of accounting for income, sales, etc., for tax purposes, an office is opened and a secretary and bookkeeper are hired. The taxpayer does none of the detail work but leaves it to his employees. In addition to consulting with investment counsel concerning changes in the portfolio, the taxpayer travels to all of the stockholder meetings held by corporations in which he is a shareholder.

There would seem to be very little doubt that so long as the office expenses, such as rent, telephone, postage, wages, etc., are directly related to the management of the security portfolio, (except as they are attributable to tax-exempt income) such expenses are deductible in computing taxable income. But the question remains, how and where are the expenses deductible when preparing the individual income tax return?

In answering this question it is necessary to look at Sections 162, 212 and 262 of the Code. Section 162 permits a deduction for all ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business. Thus, it is necessary to determine whether an individual holding securities is engaged in the carrying on of a trade or business. It has been held that the mere holding of securities for investment does not constitute a trade or business even though the taxpayer devotes his full time to this activity. Such expenses would not therefore be deductible in computing adjusted gross income.

Section 212 indicates that an individual may deduct all the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Based on the provisions of this section it seems clear that the taxpayer may deduct the various office expenses in computing taxable income so long as he itemizes his deductions and does not elect to use the standard deduction.

But what about travel expenses to stockholder meetings—can they also be deducted under Section 212, or are they precluded under Section 262 which indicates that no deduction shall be allowed for personal or living expenses? In *Godson,* 5 TCM 648 (1946), the court permitted the taxpayer to deduct traveling expenses paid in connection with a trip to Canada to look after his interests in apartment houses and in an investment company. The court indicated that the taxpayer's interests in Canada consisted of investments rather than a business regularly carried on by him, so as to preclude deducting such ex-

penses as business expenses. However, since the obvious purpose of such a trip was the management, conservation, or maintenance of income-producing property, the traveling expenses were deductible under Section 212.

In spite of the decision in the *Godson* case, the Internal Revenue Service frowns on the deductibility of such items. In Revenue Ruling 56-511, the Service held that transportation and incidental expenses incurred by a stockholder attending meetings of companies in which he owned stock were not deductible either under Section 162 or Section 212, where his purpose was to secure information relative to the companies which he thought would be useful in deciding what future investments he should make. Although the stockholder's major source of income was dividends and profits on stock transactions, the Ruling held that the travel and incidental costs constituted personal expenses under Section 262 of the Code and could not be deducted. In view of *Godson* and despite this ruling, it would seem that a pursuasive argument could be made for the deduction if the taxpayer had a substantial stock interest in the company holding the meeting and could show a good business reason for attending.

MULTIPLE REDEMPTIONS OF STOCK HELD BY ESTATE

Section 303 of the 1954 Internal Revenue Code and its predecessor, Section 115 (g)(3) of the 1939 Code, was designed to permit a redemption of stock without dividend consequences under certain conditions after the death of an individual whose estate contained a substantial block of stock in a single corporation

The initial requirement of Section 303 is that the total value of all of the stock of the corporation included in the gross estate of the decedent must be either more than 35% of the value of the decedent's gross estate or more than 50% of the taxable estate. The redemption must normally take place within ninety days after the expiration of the period of time for the assessment of the federal estate tax.

The total amount which may be paid by the corporation in redemption of stock included in a decedent's gross estate is limited to the sum of the estate taxes (including interest) and the amount of funeral and administration expenses allowable as deductions in computing the taxable estate, though not specifically restricted to such use. Accordingly, if the amount of the redemption is in excess of the allowable amount, and if the redemption cannot otherwise qualify for capital gain treatment under Section 302 or some other provision of the Code, the excess amount paid for the stock by the corporation is normally treated as dividend income to the recipient.

Neither the Code nor the Regulations, however, make provision for the resulting tax consequences in the event that more than one person who received stock from the estate of the decedent has it redeemed by the corporation. If the total amount paid to all of the shareholders redeeming stock exceeds the allowable amount under Section 303, it is clear that the excess amount will be taxable as a dividend

(assuming again that no other provisions of the tax law would operate to prevent this result). In such a case, which of the several stockholders must bear the dividend consequences?

For example, assume that a decedent dies owning stock in a corporation and that the value of the stock represents 60% of the taxable estate. The estate taxes, administration expenses and funeral expenses total $50,000. The corporation redeems part of the stock owned by the estate for $50,000. On termination of the estate the executors distribute the balance of the stock to Mr. A. Within the period prescribed in Section 303, the corporation redeems part of the stock now held by Mr. A for $50,000.

In the foregoing example, it is clear that there has been an excess distribution of $50,000 which must be treated as a dividend. Neither the Code nor the Regulations, however, give any inkling as to whether this dividend is to be taxed pro rata to each of the redeeming stockholders or is to be borne completely by the last stockholder. Valid arguments could be made for either result. It could be said that the last person to have stock redeemed should not bear the full burden merely because another party acted more promptly. On the other hand, it could be argued that the first party to sell, and who did sell believing that his sale would qualify under Section 303, should not be penalized because subsequently another party had stock redeemed which he had received from the same estate. Informal discussion of this problem with the Internal Revenue Service indicates that it will use the chronological approach.

PERSONAL HOLDING COMPANY—DIVIDEND DISTRIBUTIONS

In order to avoid the personal holding company penalty tax on undistributed personal holding company income it is usually necessary to effect a distribution of such income. Generally, when this income is distributed as dividends to the shareholders it will be taxed at rather high brackets. Thus, ways should be sought to distribute income which will result in the least impact of taxes.

One way of accomplishing this is to pay all or part of the dividend distributions in property rather than cash where the market value of the property on the date of distribution to the shareholders is less than the tax basis to the company. Reg. 1.562-1(a) provides that if a dividend is paid in property (rather than money) the amount of the dividend paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of distribution.

Furthermore, Section 301(b)(1)(A) provides that a noncorporate recipient is required to report as income only the fair market value of property received as a dividend. Thus, if a company distributes securities which have depreciated in value, the company uses the adjusted basis of the securities in determining its dividends paid deduction in computing undistributed personal holding company income. At the same time the shareholders need report as dividend income only the fair market value of the securities distributed, not the higher basis to the company.

To illustrate the effect of these provisions, assume that a corporation must pay additional dividends of $100,000 in order to avoid the personal holding company tax for the calendar year 1961. If the requirement is satisfied by a distribution of cash, the corporation will not have such funds available for investment purposes. Further, the shareholders will be required to report $100,000 as dividend income. However, if the corporation owns securities with a tax basis of $100,000, the fair market value of which is $50,000, a distribution of

such securities would result in a $100,000 dividend paid deduction for the corporation and at the same time the shareholders would be required to report only $50,000 as dividend income.

Upon the receipt of such securities the shareholders, if they desire, could sell the securities in order to have the necessary cash to pay the tax thereon. The net effect of this transaction is that taxable income in the hands of the shareholders is reduced $50,000, the corporation has additional funds available for investment, and the corporation will have satisfied the dividend paid requirement for personal holding company purposes.

It should be noted that, in the above example, the basis to the shareholders of the securities distributed is their fair market value, $50,000. Therefore, the loss between the basis to the corporation and the fair market value at the time of distribution is forfeited. In most cases, however, the advantages cited above will more than outweigh this disadvantage.

CORPUS EXPENSES BENEFIT INCOME BENEFICIARIES

One of the areas where accounting theory and tax law conflict is in the proper treatment of expenses attributable to the corpus of a trust which are used to decrease the taxable net income of the beneficiary. A recent decision (*Estate of Frank M. Dick,* N. Y. Law Journal 6/12/61) in the Surrogate's Court of New York County highlights this conflict.

In 1957 a simple testamentary trust realized net capital gains of $147,200. Under New York State law the federal income tax was paid from the trust corpus. Nevertheless, in his accounting to the court the trustee charged the income beneficiary with $15,000 of the tax. The trustee stated that the charge against income should be the lesser of (1) the saving which should have been made if the administrative expenses payable from corpus had been used as deductions from the capital gains taxable to principal, or (2) the saving which was in fact incurred by reason of the use of such deductions in reducing distributable net income taxable to the income beneficiary. The Surrogate sustained the objection of the income beneficiary to the charges against her account for the portion of the capital gains tax.

Prior to the enactment of the 1954 Internal Revenue Code the tax law did not permit deductible items paid from corpus to be applied in reduction of the income currently taxable to the beneficiary. In the absence of a tax liability payable from corpus, such as one based on capital gains, corpus deductions could not be utilized and were wasted.

The 1954 Code attempted to partially remedy this situation. Under the present Code, deductible items, such as attorneys' fees and principal commissions, although charges against corpus, must be applied in reduction of the distributable net income (Section 643(a)). The Code permits such deductions to be applied against capital gains credited to corpus *only* to the extent that the total of the available deductions exceeds the amount of gross income required to be included in the distributable net income. The result is that deductible items paid from corpus reduce the tax of the income beneficiary without giving the remainderman a tax advantage from the expenses borne by the corpus.

The Surrogate's Court in reaching its decision stated that the provisions of the Internal Revenue Code are mandatory, even though inequitable, and must be followed literally. The net result is that the income beneficiary will receive benefit, without a commensurate benefit to the corpus account from which the expenses and capital gains tax was paid.

Classified Section

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